FREEMIND
FINANCIAL ADVISORY

Traditional IRAs Explained: Everything You Need to Know

Updated: May 2024
Tags: Investing | Retirement | Tax Benefits

Introduction to the Traditional IRA

An Individual Retirement Account (IRA), often known as a "Traditional" IRA, is an investment account that helps individuals save and prepare for retirement. First introduced in 1974, the Traditional IRA has helped millions of people achieve their long-term financial objectives. This retirement account type is a popular method of long-term planning, mainly due to the significant tax benefits it offers.

Why Should I Invest in a Traditional IRA?

If managed properly, a Traditional IRA could help you attain your financial goals in the long-run. The Traditional IRA has distinct tax advantages over a standard brokerage account, specifically as it relates to the deferral of capital gains (i.e., tax-deferred growth) and tax deductibility of contributions. Here's what each of those mean:

Tax-Deferred Growth

There are two major tax-related benefits associated with investing in a Traditional IRA, the first of which is **tax-deferred growth**.

When you invest in a standard brokerage account, you pay tax on all investment gains in the year you realize those gains. This means that if you buy $1,000 worth of stock today and sell that same stock for $1,500 in the future, you will incur a tax liability on that $500 gain in the year you sell. Then, if you choose to reinvest the balance, you won't have the full $1,500 to invest with (you will have less) since some of your gain goes to paying capital gains tax.

If you invest in a Traditional IRA, however, you won't incur any tax liability on gains until you take withdrawals in retirement! In other words, you keep 100% of your investment gains until you begin taking withdrawals on the account, at which point the withdrawals are taxed as ordinary income. The impact of this **tax-deferred growth** is massive in the long-term. For example, $10,000 invested in a tax-deferred account (such as a Traditional IRA) over 40 years could be worth $30,000 more than that same amount invested in a standard brokerage account.[1]

Tax Deductibility of Contributions

The second major tax benefit of investing in a Traditional IRA relates to the **deductibility** of contributions from your annual taxes. While certain rules apply (more on this below), many individuals can reduce their taxable income on a dollar-for-dollar basis by contributing to a Traditional IRA. So, if a married couple generates $100,000 in taxable income in a given year, the couple could reduce their taxable income to $86,000 and save thousands of dollars in taxes this year simply by having each spouse contribute $7,000 to a Traditional IRA.[2]

Who Can Own and Contribute to a Traditional IRA?

First of all, you must be a real, living person to own to a Traditional IRA. You cannot open a Traditional IRA for a business the same way you could a bank account. Similarly, Traditional IRAs cannot be jointly owned—they are for one person, only.

There are no age limits for contributing to a Traditional IRA—people of all ages can contribute—and no income restrictions either, although higher income earners may not receive the same tax deduction benefits (more on this later).

Even so, not everyone is eligible to contribute to a Traditional IRA since contributions are restricted to **earned income** only. Earned income includes wages, salaries, tips, commissions, self-employment income, and any other taxable employee pay. Types of income that are not eligible for IRA contributions include investment income, interest and dividend income, earnings from rental properties, pensions, annuities, welfare benefits, unemployment benefits, worker's comp benefits, and social security benefits.

How Much Money Can I Contribute to a Traditional IRA?

In 2024, the maximum contribution to a Traditional IRA is $7,000. Those who are at least 50 years old are eligible for an additional "catch-up" contribution of up to $1,000, increasing their contribution limit to $8,000. These limits are occasionally revised in order to adjust for cost of living and inflation.

One thing to keep in mind, however, is that contributions are restricted to earned income only, which may be lower than the $7,000 (or $8,000 for 50+) contribution threshold.

Can I Deduct My Contribution to a Traditional IRA?

As mentioned earlier, one of the benefits of a Traditional IRA is that you can reduce your taxable income on a dollar-for-dollar basis with your contributions today. The deadline for claiming the deduction is the tax filing deadline, which is typically April 15 of the year following the tax year you are filing. This means as long as you contribute to your Traditional IRA by April 15, 2025, you may be able to deduct this amount from your 2024 tax filing.

The tax deductibility of Traditional IRA contributions is dependent on various factors, including income level, filing status (single, married filing jointly, other) and whether you or your spouse are covered by an employer-sponsored retirement plan, such as a 401(k).

In simplifying these rules, if neither you nor your spouse are covered by an employer-sponsored plan, then you are entitled to a full deduction. If you or your spouse are covered by an employer-sponsored plan, then certain income thresholds apply to determine whether you can take a full, partial, or no deduction.

These rules do not prevent you from contributing to a Traditional IRA; they only impact whether you can claim a tax deduction on the contribution.

What are the Withdrawal Rules of a Traditional IRA?

Traditional IRAs are subject to specific withdrawal rules that, when not followed, could result in a substantial penalty. Starting at age 59½, you may take distributions from your IRA at any time and in any amount without incurring a penalty. These distributions are included in your taxable income for the year in which you take them.

Those who withdraw funds before age 59½ are subject to penalty in an amount of 10% of the distribution, unless the distribution qualifies for an exception. The most common exceptions include distributions related to first-time homebuyers (up to $10,000), birth or adoption expenses (up to $5,000 per child), emergency personal expenses (up to $1,000 per year), higher education expenses, federally declared disasters (up to $22,000), certain unreimbursed medical expenses, and death or disability of the IRA owner.

Separately, Traditional IRA account owners must abide by **required minimum distribution (RMD)** rules. Starting at age 73, account owners are required to withdraw a certain amount from their account each year to avoid a penalty (up to 25% of the value) on the missed RMD. The amount of the RMD is calculated based on life expectancy and account balance.

What Types of Assets Can I Invest in with a Traditional IRA?

A Traditional IRA allows its account owner to invest in a fairly broad spectrum of assets. Stocks, exchange-traded funds (ETFs), mutual funds, bonds, money market funds, and certificates of deposit (CDs) are all permitted assets in an IRA. Examples of investments that are prohibited in a Traditional IRA include life insurance, artwork and collectibles, S corporation stock, and real estate for personal use, among others.

It is important to establish an allocation of assets in your IRA that best matches your financial objectives and risk tolerance. A dynamic portfolio that evolves over time can help you meet your financial needs, wants, and wishes.

Are There Other Types of Individual Retirement Accounts (IRAs)?

Yes, there are other forms of IRAs that may have specific use cases. These include:

- Roth IRA – A post-tax IRA that allows tax-free growth and withdrawals.
- Custodial IRA – An IRA held on behalf of a minor or incapacitated adult.
- Inherited IRA – An IRA one inherits as the beneficiary upon the death of someone.
- SEP IRA – An IRA with special perks for self-employed individuals or small business owners.
- SIMPLE IRA – Another type of IRA with special perks for self-employed individuals or small business owners.
- Self-Directed IRA – An IRA that allows for a broader range of investment assets, such as real estate, precious metals, commodities, and other alternative investments.

How Can I Start Investing in a Traditional IRA?

If you think a Traditional IRA is right for you, reach out to us at **FreeMind Financial Advisory** and we would be happy to provide a **free strategy session** personalized for you. We can help determine if a Traditional IRA is the best investment account for you, and if it is, we can assist in setting up your account, choosing an initial investment allocation, and actively monitoring and managing your retirement balance.

GET IN TOUCH AND LEARN MORE AT FREEMINDFINANCIAL.COM

Footnotes

[1] Assumptions include (a) 8.0% annual return on portfolio, (b) 25% annual rebalancing of the total portfolio, and (c) 20% long-term capital gains tax rate.

[2] Although Traditional IRA contributions may be deductible in the year of contribution, those contributions will be taxable as income when withdrawn in the future. Lifetime tax savings are subject to numerous factors, primarily (a) current and future tax rates and (b) current and future income.