A Big Tax Loophole Just Got Bigger

By Wayne M. Davies

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A Big Tax Loophole Just Got Bigger: How To Turn Taxable Income Into Non-Taxable Income -- Legally!

-- by Wayne M. Davies

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Believe it or not, there are ways to convert taxable income into non-taxable income, without any fear of an IRS audit.

Here's one of my favorites. It's been part of our beloved tax code for over 30 years, yet many still don't take advantage of it.

What am I talking about?

The IRA -- Individual Retirement Account.

Now, before you say, "Oh, I know all about that one; what's so great about an IRA?", give me 10 minutes to explain 3 new benefits to the IRA rules that you may not realize.

BENEFIT #1: How To Avoid Tax Rather Than Postpone Tax

First, did you know that there are now 2 kinds of IRA's available?

The so-called "Traditional IRA" is the one that first came out way back in the 1970's.

But there's a newer incarnation of the IRA that's only a few years old -- it's called the "Roth IRA".

What's the difference between a Traditional IRA and a Roth

IRA? There's a HUGE difference!

"Traditional" IRA contributions are tax-deductible, and the growth of those contributions is also "tax-sheltered" while the funds remain in the account.

But eventually all tax-deductible "Traditional" IRA contributions, as well as the growth of those contributions, will be subject to income tax when the money is withdrawn from the account.

In other words, Traditional IRA's offer the opportunity to POSTPONE taxes. Traditional IRA's enable you to save taxes --- but these tax savings are only TEMPORARY!

This is the big difference between Traditional IRA's and Roth IRA's: Traditional IRA's allow you to temporarily POSTPONE taxes. The Roth IRA offers the opportunity to permanently AVOID taxes.

With a Roth IRA, you don't take a deduction for your contributions; instead, you make a contribution with "after-tax" dollars.

But whatever you put in not only grows tax-free, but can also be withdrawn tax-free.

Here's an example to illustrate:

If you invest $2,000 per year for 20 years into a Roth IRA, you will have invested a total of $40,000. Now if that Roth IRA earns an average of 10% per year, that $40,000 will grow into $126,005.

Now comes the fun part: Assuming the IRA has existed for at least 5 years and you are at least 59 ½ years old, you can withdraw the entire $126,005 TAX-FREE!

In contrast, if this money had been invested in a Traditional IRA, the entire $126,005 would be subject to income tax as it is withdrawn.

The $86,005 of growth is magically converted from taxable income to non-taxable income. Assuming you are in the 15% federal tax bracket, that's a savings of $12,901. Add any state income tax, and you could save well over $15,000 in taxes.

And $15,000 buys a lot of pizza in my house!

BENEFIT #2: Take An Extra 3 ½ Months To Fund Your IRA

The deadline for contributing to your IRA is April 15 of the year AFTER the year for which the contribution made. (Boy, I'm starting to sound like a lawyer now, aren't I?)

In other words, for Year 2002, you have until April 15, 2003 to put money into your IRA.

If you've already invested the maximum (more about that in a moment) by December 31, 2002, then you're done. No more money can go into the IRA for 2002.

But when January 1 rolls around, if you haven't mixed out your IRA, you have until April 15 to do so.

Which brings me to . . .

BENEFIT #3: The Maximum Contribution Amounts Have Increased

For many years, the most you could put into an IRA was $2,000. Now, the maximum is $3,000 (assuming you have at least that much earned income from wages or self-employment income).

And if you are over 49, you can put in another $500, bringing the total maximum to $3,500.

A married couple, both age 50 or older, can put a whopping $7,000 per year into a Roth IRA. Not too shabby, eh?

One final note about these Roth IRA rules: For married people, you can only contribute the maximum of $3,000 or $3,500 if your combined income is less than $150,000.

If you are single or head of household, you can contribute the maximum if your income is less than $95,000.

(I hate rules like that, don't you!)

For most middle-class folks looking for a perfectly legal way to permanently avoid tax (rather then merely temporarily postpone tax), the Roth IRA fits the bill!

Now comes the hard part -- how to actually implement this tax avoidance strategy.

"Wayne", you say, "I'm getting close to retirement and so my wife and I are trying to save as much as we can for our golden years. But $7,000 a year? It's hard to put aside that kind of money. We need every dollar we make just to pay the bills."

If that's your situation, I'm not going to get up on my

"what-do-you-mean-you-can't-save-any-money-for-retirement"
soapbox and start preaching at you.

I will say this: You've got to start somewhere, and you've
got to start saving something -- right now!

Don't put off saving for retirement. The longer you wait,
the harder it gets to get started.

People who have a problem saving for retirement usually have
a budgeting problem. And budgeting is beyond the scope of
this article.

For an excellent resource on budgeting, I highly recommend
the Budget Stretcher web site: http://www.homemoneyhelp.com .

This site offers a free budget system complete with simple
forms and worksheets to help you figure out how to put some
money aside for a Roth IRA or other savings plan.

Take advantage of this free resource!

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Wayne M. Davies is author of the new eBook, "The Tax
Reduction Toolkit: 29 Little-Known Legal Loopholes That Will
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