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RETIREMENT PLANNING SERIES

Individual Retirement Accounts

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Understanding Individual Retirement Accounts and the Methods to Use Them

Individual retirement accounts (IRAs) are available in multiple forms, but the two most commonly recognized types are Traditional IRAs and Roth IRAs. Additional options are the Simplified Employee Pension (SEP) IRA and the Savings Incentive Match Plan for Employees (SIMPLE) IRA, which are generally considered alternatives to employer contribution plans. This paper will focus on the first two types, Traditional and Roth IRAs.

An IRA can be either a primary retirement savings vehicle or a way to supplement retirement savings when an employee has a workplace plan. When a workplace plan is unavailable, an individual should prioritize an IRA as the primary method of saving for retirement. An individual can contribute to a Traditional IRA even when participating in a workplace retirement plan; however, the individual's income level may place some limitations on their ability to contribute to a Roth IRA (https://www.irs.gov/publications/p590a) and tax deductibility may not apply for Traditional IRA contributions.

Traditional IRA

The Traditional IRA was created as part of the Employee Retirement Income Security Act of 1974 (ERISA). It allows for tax-deferred growth, which means that an IRA holder does not pay tax on the gains until making a withdrawal. When funds are withdrawn, they are considered income for tax purposes and do not receive capital gains treatment. For example, an IRA holder who withdraws $50,000 from an IRA will be considered by the IRS to have earned $50,000 during the year of withdrawal in addition to any other income they may receive that year.

Anyone with earned income can contribute to an IRA, but the deductibility of an individual's contributions depends on their tax filing status and whether they have a workplace retirement plan. The Internal Revenue Service (IRS) provides a resource page (https://www.irs.gov/retirement-plans/ira-deduction-limits) with links to details about the deductibility of contributions based on the presence or absence of a workplace plan. Individuals should refer to this IRS information when considering the deductibility of their Traditional IRA contributions.

The main benefit of a Traditional IRA is tax-deferred growth, which allows account holders to let their funds grow for many years before owing taxes on their investments. IRA holders can also buy and sell within their account and face no tax consequences. The ability to deduct contributions from taxable income is another potential benefit, but there are limitations (see the IRS resource page link above).

Any funds contributed to a Traditional IRA should be earmarked for retirement purposes. In the event the account holder needs to withdraw funds early, there is typically a 10% early withdrawal penalty for distributions from an IRA taken prior to reaching the age of 59 1/2. The withdrawal amount must also be reported as taxable income in the year it is withdrawn. However, the early withdrawal penalty can be avoided in certain situations, such as when using $10,000 for a first-time home purchase, paying for unreimbursed medical expenses totaling more than a certain percentage of adjusted gross income, or taking a series of substantially equal distributions. The IRS provides a complete list of situations that do and do not qualify for an exemption from the early withdrawal penalty (https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions).

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A required minimum distribution (RMD) is a mandatory withdrawal imposed by the IRS on Traditional IRAs once the account holder reaches a certain age (currently set at age 72 for 2021). An RMD is calculated based on the balance at the end of the prior year divided by a divisor set by the IRS. The IRS provides a worksheet with directions on how to calculate an RMD (https://www.irs.gov/pub/irs-tege/uniform_rmd_wksht.pdf). Traditional IRA holders subject to RMDs are forced to take distributions they might not have otherwise taken, meaning that RMDs present a downside of Traditional IRAs because more taxable income gets reported and more taxes are paid than might otherwise be necessary. Individuals who do not need funds from their IRAs to maintain their lifestyle tend to find the RMD rules burdensome, but deciding not to take the RMD is not a viable solution. A 50% penalty is imposed on the amount of an RMD that is not taken, which means that the IRA holder will owe the IRS income tax on the amount withdrawn plus 50% of the total RMD amount not taken before the end of the year. For example, an IRA holder with a $200,000 RMD who chooses to withdraw only $100,000 will owe the IRS $50,000 (half the amount not withdrawn) as a penalty.

Roth IRA

Senator William Roth sponsored the legislation that created a new type of IRA as part of the Taxpayer Relief Act of 1997, resulting in the Roth IRA bearing his name. Roth IRAs are post-tax accounts, which means no tax deduction is taken in the year in which funds are contributed into the account. Since there is no up-front tax benefit, funds are not subject to income tax when withdrawn from the account.

The tax-free withdrawal at the point of distribution is the main differentiator of Roth IRAs. It is important to note that a Roth IRA distribution of earnings needs to occur five years or more after the first contribution for the withdrawal to be tax-free; contributions can always be withdrawn tax-free. Account holders may also be subject to the same 10% early withdrawal penalty on such earnings withdrawals that applies to Traditional IRAs unless they meet certain IRS exemptions (refer again to the IRS link above for clarity on situations that avoid the early withdrawal penalty).

Unlike Traditional IRAs, Roth IRAs are not subject to RMD rules, so account holders do not have to withdraw funds if they do not desire to. For those that would otherwise prefer to forgo distributions or would like to better control income tax implications during retirement, a Roth IRA will prove beneficial. There are limitations, though, on who can make direct contributions to Roth IRAs. The IRS has established income metrics, based on income earned in a given year, that determine a person's eligibility. The IRS's determination is based on modified adjusted gross income (MAGI) and is explained in IRS Publication 590-A (https://www.irs.gov/publications/p590a#en_US_2020_publink100025076). For example, an individual earning $215,000 in 2021 would not be allowed to directly contribute to a Roth IRA.

Roth Conversion

For those who already have Traditional IRAs but see the long-term benefit of converting some or all of their Traditional IRA funds into a Roth IRA, it is possible to complete what is called a Roth conversion. The tax consequences of a Roth conversion are important to understand. Whatever amount is converted to a Roth IRA is treated as taxable income of the account holder in the year of conversion. For example, assume that an individual together with his or her spouse has $200,000 in earned income in 2021 and files taxes using the married filing jointly status. Assume further that the individual converts his or her entire Traditional IRA with a value of $250,000 to a Roth account in 2021. The IRS would consider the couple's earned income for tax purposes to be $450,000, which would push them up two income tax brackets, from 24% to 35%. This would increase the taxes owed to the IRS by approximately $70,500 for the year.

When contemplating a Roth conversion, tax considerations are key. Taking advantage of years when taxable income may be lower and converting portions

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each year as a way to avoid higher tax brackets can prove beneficial. Another consideration is whether there is sufficient time to recover from the tax impact of the conversion. A conversion at age 35 provides more time for the investment growth to recover the taxes paid than does a conversion at age 65. If there are ample assets to meet a person's lifetime income needs, a Roth conversion can allow that person to avoid unnecessary RMDs and, from an estate planning perspective, to pass assets to beneficiaries free of income tax. Anyone considering a Roth conversion should consult with tax and investment professionals to determine whether it is a sound strategy for the individual's particular situation.

Backdoor Roth IRA

The income limits on Roth IRA contributions mentioned above have led to a strategy known as the backdoor Roth IRA. A backdoor Roth IRA is a tactic pursued by those whose high income prevents them from contributing directly to a Roth IRA. The individual must have both a Traditional IRA and a Roth IRA, and, to avoid tax impact, it is best for the Traditional IRA not to contain any initial funds. Since there is no income limitation on individuals contributing to a Traditional IRA, the first step is to make the desired contribution to the empty Traditional IRA. Next, these funds are converted from the Traditional IRA to the Roth IRA. This approach negates the ability to take a tax deduction for the contribution to the Traditional IRA, and it is generally considered prudent to wait to invest the funds until they are within the Roth IRA.

Contribution Limits

Regardless of the account holder's income, Traditional and Roth IRAs are both subject to limits on how much may be contributed. An individual can contribute up to $6,000 of earned income to an IRA in 2021. If the individual is aged 50 or older, an additional $1,000 contribution from earned income is allowed. These limits are periodically adjusted upward for inflation, so it is important to pay attention to IRS announcements regarding contribution limit increases. This IRA contribution limit applies to IRAs collectively. This means that owning more than one IRA does not allow someone to make the maximum contribution to each IRA. For example, if an individual is under the age of 50 and has both a Traditional IRA and a Roth IRA, a total of only $6,000 can be contributed between the two IRAs. As a reminder, the ability to contribute to the Roth IRA may also be limited by income level (see the Roth IRA section above).

Summary

Individual retirement accounts are an effective vehicle for retirement savings. Whether as the main source of retirement savings or as a supplement to a workplace retirement plan, IRAs should be utilized as an important part of retirement planning. To determine the best overall approach, individuals are encouraged to consult with tax and financial planning professionals to determine the best IRA strategy based on the specifics of their financial situation.

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