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Tax-Saving Retirement Investment Accounts

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Depending on your age, employment status, and income level, you may be able to take advantage of one or more tax-saving retirement investment accounts. It is generally advisable to put retirement savings first in 401(k), Keogh or other employer-sponsored retirement plan accounts, especially if your employer offers matching contributions (which are essentially free money). This is because you can generally put away substantially more money into an employer-sponsored plan account than other types of retirement accounts (like IRAs). By first setting aside savings to fund such company retirement accounts, you both increase the amount of current tax deductions and shield a larger sum whose returns are tax deferred. Of course, this advantage could be reduced or completely negated by a poor set of investment choices offered by your employer's retirement plan.

After maxing out contributions to your employer-sponsored retirement plan accounts, you should next consider contributing to a Traditional IRA, a Roth IRA, or both. Contribution eligibility differs for these two types of IRAs.

Contributions to a Traditional IRA can be made at any age as long as you have taxable compensation income; your contributions ***may*** be tax deductible (depending on several factors discussed on the next page). After you reach age 70 ½ if you were born before July 1, 1949 or age 72 if you were born on or after July 1, 1949, you must begin withdrawing required minimum distributions ("RMDs") from the Traditional IRA. Assets in the account will grow tax-***deferred***, with any investment earnings and deductible contributions subject to ordinary income tax at eventual distribution. Distributions are also subject to a 10% early-withdrawal penalty if they occur before you reach age 59 ½, unless one of few exceptions applies.

Roth IRA contributions (which are never tax deductible) can be made at any age as long as you have taxable compensation income, but only if your modified adjusted gross income falls within specified limits. Those limits for 2021 are described on the next page.

Assets in a Roth IRA will grow tax-***free*** while in the account, and ***contributions*** can be withdrawn at any time without incurring income tax or penalties. Distributions of the investment ***earnings portion*** of the account will also be free from income tax and penalties if they occur after 1) the 5-year period starting with the first tax year for which a contribution was put into the Roth IRA, and 2) you have reached age 59 ½; you are disabled or deceased; or you are making a qualifying first-time home purchase (up to $10,000 lifetime limit). In this way, Roth IRAs offer tax-***exemption***, rather than simply tax-deferral. Also,

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the required minimum distribution rules for Traditional IRAs do not apply to Roth IRAs during your lifetime, which helps you continue building retirement assets on a tax-free basis for a longer time period.

Here are the 2021 Roth IRA eligibility parameters.

Tax Filing Status	2021 Modified AGI	2021 Roth IRA Contribution Limit
married filing jointly or **qualifying widow(er)**	< $198,000	The lesser of $6,000 (or $7,000 if you will be at least 50 years old by 12/31/2021), or 100% of your taxable compensation
	$198,000 ≤ X < $208,000	Less than the limit stated above
	≥ $208,000	$0
married filing separately (and you lived with your spouse at any time during the year)	$0	The lesser of $6,000 (or $7,000 if you will be at least 50 years old by 12/31/2021), or 100% of your taxable compensation
	$0 < X < $10,000	Less than the limit stated above
	≥ $10,000	$0
single, **head of household**, or **married filing separately** (and you did not live with your spouse at any time during the year)	< $125,000	The lesser of $6,000 (or $7,000 if you will be at least 50 years old by 12/31/2021), or 100% of your taxable compensation
	$125,000 ≤ X < $140,000	Less than the limit stated above
	≥ $140,000	$0

Source: IRS Publication 590-A

So which type of IRA is better for you? First, you need to determine whether you are eligible to contribute to either one or both. If you are ineligible to contribute to a Roth IRA, then a Traditional IRA may be your default option. Assuming you are eligible to make a full contribution to either a Traditional or Roth IRA, which one is preferable depends on a whole host of factors. One of the most important issues is whether your contributions to a Traditional IRA are fully deductible. This in turn depends on your filing status, modified AGI and whether you and/or your spouse are covered by a retirement plan at work. The table on the next page summarizes the 2021 tax rules for deducting Traditional IRA contributions based on these factors.

If you can fully deduct your Traditional IRA contribution <u>and</u> your ordinary income tax rate is projected to be at least several percentage points lower at retirement, you will likely be better off making the entire contribution to a Traditional IRA, because the immediate positive impact of the tax deduction plus the benefits from investing these tax savings over time would in many cases outweigh the back-end benefits of tax-exemption and RMD-exemption from a Roth IRA.

However, if your ordinary income tax rate at retirement is unlikely to drop at least several percentage points from your current rate, then the back-end, tax-exempt and RMD-exemption benefits of a Roth IRA would likely outweigh the immediate benefit of a tax deduction and any related investment gains on such tax savings. This is because the value of the Roth IRA tax exemption increases proportionally to rising tax rates. In this event, the Roth IRA is more beneficial for you even if you are able to deduct your contribution to a Traditional IRA.

2021 IRA Deduction Limits:

You Are Covered By a Retirement Plan at Work	Tax Filing Status	2021 Modified AGI	2021 Traditional IRA Contribution Deductibility
Yes	**single** or **head of household**	≤ $66,000	Full
		$66,000 < X < $76,000	Partial
		≥ $76,000	None
	married filing jointly or **qualifying widow(er)**	≤ $105,000	Full
		$105,000 < X < $125,000	Partial
		≥ $125,000	None
	married filing separately[1]	< $10,000	Partial
		≥ $10,000	None
No	**single**, **head of household**, or **qualifying widow(er)**	Any	Full
	married filing jointly or **separately** (spouse **<u>is not</u>** covered by a plan at work)	Any	Full
	married filing jointly (spouse **<u>is</u>** covered by a plan at work)	≤ $198,000	Full
		$198,000 < X < $208,000	Partial
		≥ $208,000	None
	married filing separately (spouse **<u>is</u>** covered by a plan at work)[2]	< $10,000	Partial
		≥ $10,000	None

1. If you didn't live with your spouse at any time during the year, your filing status is considered Single for this purpose.
2. You are entitled to the full deduction if you didn't live with your spouse at any time during the year.

Source: IRS Publication 590-A

If you cannot deduct your Traditional IRA contribution at all, then you will not receive any upfront tax benefits from contributing to a Traditional IRA. In this case, contributing to a Roth IRA will be a better choice for you, as it will allow you to benefit from tax-free distributions at retirement and exemption from RMDs.

What if your contribution to a Traditional IRA is only ***partially*** deductible? Your ability to make contributions to both a Traditional and a Roth IRA in the same tax year, subject to overall limits, offers you some planning tools to address this situation. If your contribution to a Traditional IRA is only *partially* deductible, it is advisable to contribute the maximum permitted deductible amount to a Traditional IRA (assuming your ordinary income rates are projected to be at least several percentage points lower at retirement) and to contribute the remaining allowable amount to a Roth IRA. However, you need to be aware that this arrangement will likely result in higher administrative and brokerage costs than if you invest all your contributions in a single type of IRA.

For 2021, the ***aggregate*** contribution limit for all your Traditional <u>and</u> Roth IRAs is the <u>lower</u> of 1) 100% of your taxable compensation, or 2) $6,000 (or $7,000 if you will be at least 50 years old by December 31, 2021). For example, if you are qualified to contribute to both types of IRA and your aggregate contribution limit is $6,000, you may contribute all $6,000 to either a Traditional or Roth IRA, or split the $6,000 between the two types of IRA. Contributions to a Traditional and/or a Roth IRA can be made up to the tax filing deadline (not including extensions) for the tax year to which such contributions relate. You therefore have until April 15, 2022 to make IRA contributions for 2021.

If the situation is too close to call between contributing to a Traditional versus a Roth IRA, there are reasons to favor the Roth IRA over a Traditional IRA. First, the Roth IRA does not require mandatory distributions at 70 ½ if you were born before July 1, 1949 or age 72 if you were born on or after July 1, 1949, permitting the assets to continue growing in a tax-exempt way. Second, your contributions (i.e. your principal) in a Roth IRA can be withdrawn at any time without income tax or penalty. However, balanced against these advantages is the reality that Congress can always limit or eliminate the back-end tax-exempt status of the Roth IRA in the future, though adverse political ramifications would discourage any such change.

If you are ineligible to contribute to a Roth IRA, then a Traditional IRA may become your default option. It is a common misperception that you are not eligible to make contributions to a Traditional IRA if you are already covered by a retirement plan at work and/or your salary exceeds certain limits. In fact, coverage by a retirement plan at work and high income levels only affect your ability to deduct your contributions and enjoy the front-end tax benefits; they do not affect your right to make an annual contribution and enjoy at least the back-end benefits of tax deferral. As long as you have taxable compensation income, you are eligible to contribute to a Traditional IRA, even if your contribution is not deductible. Making non-deductible contributions to a Traditional IRA still yields tax benefits, because all investment earnings are tax-deferred, despite the inability to deduct the contribution upfront.

If you are ineligible to contribute to a Roth IRA, the choice is between making a contribution to a Traditional IRA versus keeping the contribution in a more accessible taxable account. The choice is easy if your contribution is deductible. Because of the immediate benefits of the tax deduction and the tax-deferral features of a Traditional IRA, you will be better off economically in almost all cases if you save by making the deductible contribution to a Traditional IRA rather than keeping the money in a more accessible taxable account.

The decision whether to make a ***non-deductible*** contribution to a Traditional IRA versus keeping the contribution in a more accessible taxable account depends on a number of factors: a) the difference between your current ordinary income tax rates versus those projected at time of withdrawal; b) how much of your total annual account return is realized for tax purposes; c) how the realized annual account return is likely to be allocated among short-term and long-term capital gains and ordinary income; and d) how your short-term and long-term capital gain tax rates compare to your ordinary income tax rates, both during the accumulation and the distribution phases of your IRA. You are more likely to benefit from making the non-deductible IRA contribution if your ordinary income tax rates are projected to drop over time; the part of your annual total return that is realized for tax purposes goes up; the portion of realized account return each year subject to higher ordinary income rates increases; and the gap between your ordinary income tax rate and long-term capital gain tax rate decreases as you approach your withdrawal phase.

As you can see, there are a number of tax-saving retirement investment accounts for which you may be eligible. Prioritizing and choosing between them is difficult, given the complexities of the related tax issues. But your potential tax savings over time can be substantial, so it is worthwhile to think through your choices carefully.