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**Understanding IRA Options & Mistakes to Avoid**

**In 2021, there was an estimated 13.9 trillion dollars in Individual Retirement Accounts (IRAs) which represented almost double what was estimated to be in 401(k) plans at approximately 7.7 trillion dollars.[[1]](#footnote-1) This differential will likely grow as Baby Boomers retire at around 10,000 per day and will likely roll over their company retirement plans to IRAs for more investment options. To make wise and informed decisions and avoid costly mistakes, it is critical to understand IRAs and the maze of rules and options surrounding them for retirement income, tax, and estate planning considerations.**

The traditional IRA was first authorized by the Employee Retirement Income Security Act of 1974 (ERISA), which allowed workers who did not participate in a pension plan at work to make up to $1,500 contribution to an IRA in their name for that year. Later, the Economic Recovery Act of 1981 allowed workers' spouses to become eligible to make IRA contributions.

The Tax Reform Act of 1986 expanded the eligibility for tax-deductible contributions to individuals who also participate in an employer sponsor plan but with earnings below specified thresholds.

The limits of IRA contributions have risen from $1,500 in 1974 to $6,000 in 2022. In addition, the Economic Growth and Tax Relief Reconciliation Act of 2001 made provisions for those age 50 and older for an additional “catch-up” contribution of $500 beginning in 2002.

Today, the catch-up contribution is $1,000 for those 50 and older, in addition to the regular contribution limit of $6,000, allowing someone age 50 or older a maximum combined contribution of $7,000.

IRAs can also be funded with employer plan rollovers. There are four triggering events that may allow for a lump sum IRA rollover from an employer plan:

1. Death of the employee
2. Disability of the employee
3. Separation from service
4. Reaching age 59 ½ (only if the plan allows the employee In-Service Distributions while still employed to better diversify and plan for retirement). Employees can still participate in the employer retirement plan if they elect an In-Service Distribution.

People contributing to IRAs and some 401(k)s and other employer-sponsored plans may have a choice to make contributions to a traditional IRA/401(k) (pre-tax/tax-deductible) or to a Roth IRA/401(k) (after-tax/non-tax-deductible) depending on their eligibility.

The traditional pre-tax contributions (seeds) provide a tax deduction on the seed dollars contributed, but distributions (harvest) will be taxable.

Roth contributions are made with after-tax contribution seed dollars and therefore do not get a tax deduction upfront, but distributions (harvest) are 100% tax-free if distributions are qualified. For Roth distributions to be qualified, two conditions must be met:

1. The owner must be 59 ½, dies, or becomes disabled, AND
2. The account must have been established for five years.

The pre-tax or after-tax Roth contribution choice boils down to whether a person wants tax benefits on the contributions/seeds today or on the qualified distribution/harvest later.

**Traditional vs. Roth IRAs - The Similarities**

**Eligibility.** To be eligible to make traditional or Roth IRA contributions, the account owner, or their spouse, must have *“earned income”* in the tax year of the contribution up to the contribution amount. Earned income is from working as an employee or from self-employment net income. Pension, rental, or investment income is not earned income.

Before 2020, traditional IRA contributions were not available to those over 70 ½, but the SECURE Act of 2019 changed that, and beginning in 2020, traditional IRA, as well as Roth IRA contributions, are available to all ages if they or their spouse have earned income for that year.

**TIP:** Children who have *“earned income”* can make IRA contributions.A baby paid for modeling or paying your child or grandchild to do chores around the house is considered earned income. A minor would require a custodial IRA. Contributing to the Roth IRA may be best for children since they are usually in low-income tax brackets, and qualified distributions can be tax-free after age 59 ½.

It is essential to document children's earnings and perhaps even file a tax return for them, even if not required, to record their earned income for that year.

***Example*:** If a child started contributing to a Roth IRA at the age of 10 with $1,000 per year, age of 18 with $3,000 per year, age of 24 with $6,000 per year, and age of 50 at $7,000 per year, at an average rate of return of 8%, they would have accumulated approximately $2,624,218. At a 10% average rate of return, the accumulated value would be almost double at $5,119,869.

***The rule of 72 tells us how long it will take to double your money by dividing the assumed rate of return into 72.***

***Examples:***

72/2% rate of return = 36 years

72/8% rate of return = 9 years

Remember, Roth IRA account distributions may be 100% tax-free if the distributions are qualified versus being 100% taxable from a traditional IRA.

**Retirement Saver’s Credit**. Another important tax benefit some may also be eligible for is the Retirement Saver’s Credit which is available for those who make traditional, Roth, and other company-sponsored retirement plan contributions and who have Modified Adjusted Gross Income (MAGI) below certain levels.

To be eligible for this credit, a person must:

1. Be age 18 or older
2. Not be claimed as a dependent on another person’s return, and
3. Not be a student

The maximum amount of credit a person may earn is $1,000 ($2,000 if married and filing jointly).

The 2022 Retirement Saver's Credit phaseouts are:

* Married filing jointly; the phaseout begins at $41,000 to $68,000
* Head of household; the phaseout starts at $30,750 to $51,000.
* Singles and married individuals filing separately; the phaseout starts at $20,500 to $34,000

A $1 credit offsets $1 in taxes owed and is far more valuable than a $1 tax deduction. In contrast, a $1 tax deduction for someone in a 22% marginal tax bracket would be worth 22 cents.

Learn more about Retirement Saver’s Credit at:

<https://www.IRS.gov/retirement-plans/plan-participant-employee/retirement-savings-contributions-savers-credit>

**Tax-deferred.** The traditional IRA and the Roth IRA offer tax-deferred growth of the investments within the account.

**10% Early distribution penalty tax.** The purpose of making contributions to IRAs is to save for retirement. For owners who take early distributions from traditional IRAs and nonqualified distributions from Roth IRAs, there is an additional 10% early penalty tax assessed on early distributions unless the owner meets one of the following exceptions:

1. turns 59 ½
2. dies *(Roth IRA 5-year rule since inception applies to beneficiaries also)*
3. becomes disabled
4. receives “substantially equal payments over the owner’s life expectancy” under Internal revenue Code (IRC) 72(t)
5. for unreimbursed medical expenses in >7.5% of AGI (>10% if age 65)
6. for medical insurance premiums if unemployed
7. for higher education expenses as defined by IRC, Title 26, Section 529(e)(s)
8. to build, buy, or rebuild a first home up to a $10,000 distribution limit
9. for expenses for a qualified birth or adoption of a child up to $5,000 per child
10. a reservist is called to active duty after September 11, 2001.

**Rollovers.** Rollovers are transfers from one retirement plan to another and do not incur the 10% early distribution penalty. Direct rollovers are direct from custodian to custodian, which can happen an unlimited number of times.

The other rollover is an indirect rollover when a check is payable to the IRA owner, and the owner has 60-days to roll the funds over to the new IRA. **CAUTION:** **An indirect IRA can ONLY happen once every 12 consecutive months.**

**Traditional vs. Roth IRAs - The Differences**

**Deductibility of traditional IRA contributions:** Contributionsto traditional IRAs may be tax-deductible for the year contributed, depending on whether you are your spouse participates in a company-sponsored retirement plan and your Modified Adjusted Gross Income (MAGI). MAGI is the combination of Adjusted Gross Income (AGI), non-taxable Social Security, tax-exempt income, as well as some recaptured tax deductions.

For IRA owners and spouses covered by an employer-sponsored retirement plan, the traditional IRA deductible phaseouts are:

* Single taxpayers covered by a workplace retirement plan; the phaseouts begin at $68,000 to $78,000 MAGI
* Married couples filing jointly. This applies when the spouse making the IRA contribution is covered by a workplace retirement plan; the phaseouts begin at $109,000 to $129,000 MAGI.
* A taxpayer not covered by a workplace retirement plan married to someone who's covered; the phaseouts begin at $204,000 to $214,000 MAGI.
* Married filing a separate return. This applies to taxpayers covered by a workplace retirement plan; the phaseout begins at $0 to $10,000 MAGI.

**If you or your spouse does not participate in a retirement plan at work, then there is no MAGI phaseout, and you can deduct 100% of the traditional IRA contribution.**

Now, if your deduction for a traditional IRA contribution is phased out, a non-deductible traditional IRA contribution can still be made with after-tax dollars (no tax deduction). Remember to file the IRS Form 8606. This approach is called the *Backdoor Roth IRA* because you are funding non-deductible IRAs with after-tax dollars with the potential to convert to a Roth IRA later.

**Roth IRA Conversions.** A traditional IRA owner can convert any amount of a traditional IRA, at any age, to a Roth IRA if they are willing to pay the taxes on the converted amount since it is taxed just as distribution would be taxed. The ideal window of opportunity to convert may be just after retirement and before Social Security and required minimum distributions from IRAs begin to help keep you in a low marginal income tax bracket.

**Taxation of traditional IRA Distributions and Roth IRA conversions**. When an amount of a traditional IRA is converted to a Roth IRA, the amount converted is taxed in the same way as if a person took a distribution from the IRA. If the amount distributed/converted is from a 100% pre-tax account, then 100% of the amount will be taxable.

When an amount of a distribution/conversion contains both pre-tax and after-tax contributions, then the *Pro-Rata Rule* must be used to determine the tax-free exclusion ratio by aggregating the value of all traditional IRAs, including SEP IRAs and SIMPLE IRAs, and then dividing the amount of all after-tax contributions by the aggregate value of all IRAs to determine the tax-free exclusion percentage.

**Example:**

Susie has two traditional IRAs with an aggregate value of $100,000 and consisting of the following amounts:

$10,000 of after-tax (non-deductible) contributions

$40,000 of pre-tax (tax-deductible) contributions

$50,000 of total earnings

$100,000 Total value of both IRAs

$10,000 after-tax contributions / $100,000 Total value = **10% of distributions/conversion will tax-free and 90% will be taxable.**

**Roth IRA Distribution Ordering Rules.** Unlike thePro-Rata Rule used to calculate taxation on traditional IRAs, Roth IRAs follow the Ordering Rules, which state the order in which distributions are made.

First – Contributions (tax-free at any age)

Next – Taxable Roth Conversions (tax-deductible

 contributions taxed when converted)**\***

Next – Non-Taxable Conversions (non-deductible

 contributions not taxed when converted)**\***

Last – Earnings (tax-Free if qualified distributions)

**\*** *Each Roth conversion carries a separate 5-year rule to recapture the 10% penalty for pre-59 ½ conversion amounts if they are distributed from the Roth IRA within five years or before 59 ½ is reached.*

**Roth IRA Contribution Phaseouts**:

The phaseouts for Roth IRA contributions are:

* Single taxpayers and heads of household begin at $129,000 to $144,000
* Married, filing jointly begin at $204,000 to $214,000
* Married, filing separately $0 to $10,000

Roth IRA contributions are always made with after-tax dollars. People should start funding the Roth IRAs at an early age because as we mature and earn more income, our contributions are quickly phased out, as illustrated above.

There is no tax deduction for making contributions to a Roth account, but qualified distributions from Roth IRAs are always 100% tax-free. Distributions are Qualified when BOTH of the following conditions are met:

1. When the owner turns 59 ½, dies, or becomes disabled, AND
2. The account has been established for five years.

To sum up the differences, with the deductible Traditional IRA you get a tax deduction or benefit for your contribution or (seed dollars) for the year it was made, but the distributions (harvest) made later will be 100% taxable.

With the Roth IRA, you do not get any tax deduction on your contributions (seed dollars) made with after-tax dollars, but qualified distributions (harvest) will be 100% tax-free to you and your heirs. Qualified distributions are when:

1. they are made after 59 ½ due to death or disability, AND
2. the account is five years old.

The year the first contribution was made for, or the first Roth IRA conversion, starts the 5-year clock on January 1st of that year.

**Example:** John made his first Roth IRA contribution on March 15, 2022, for the tax year of 2021. His 5-year clock begins on January 1st of 2021.

**Traditional IRAs have Required Minimum Distributions (RMDs).** The SECURE Act, signed into law in December 2019, made several significant changes to retirement plans. One change was to change the age from 70 ½ to 72 (for those who turned 70 ½ in 2020 or later) when RMDs would be required to be taken. To recap distributions:

* **Early distributions** before age 59 ½ are subject to the 10% additional tax penalty.
* **Regular distribution**s after age 59 ½ do not pay the early penalty tax
* **Late or Required Minimum Distributions** are required at age 72 for those who turned 70 ½ in 2020 or later and are based on the Uniform Lifetime Table that estimates our life expectancies to determine the amount of the RMD for each year. As each year passes, the factor used will decrease.

**Roth IRAs DO NOT have Required Minimum Distributions (RMDs).** Another benefit of the Roth IRAs is that they do not have Required Minimum Distributions like traditional IRAs do.

**CAUTION:** Roth 401Ks do have RMDs. A way to avoid them would be to roll over to a Roth IRA at retirement.

**Inherited IRAs.** The SECURE Act of 2019 also made significant changes for the beneficiaries of Inherited IRAs. Those beneficiaries who have inherited IRAs before 2020 can still stretch their RMDs over their remaining life expectancy in many cases.

But, beginning in 2020, many who inherit IRAs from IRA owners who pass away in 2020 or later may have a much more limited time of just ten years to liquidate the inherited IRA except for Eligible Designated Beneficiaries. The SECURE Act contains three types of beneficiaries:

1. **Eligible Designated Beneficiaries** are defined as (1) surviving spouse, (2) the account owner's child under the age of majority, (3)a person who is disabled per IRC Section 72(m)(7), (4) a person who is chronically ill per IRC Section 7702B(c)(2), and (5) person who is not more than ten years younger than the deceased account owner. *In short, these beneficiaries will be able to continue to stretch the IRA distributions using their single life expectancy except for minor children, who will have ten years to liquidate the account after they reach the age of majority in their state.*
2. **Non-Eligible Designated beneficiaries** are all other *individuals* not listed above in #1. *They have ten years after the date of death to have the IRA fully liquidated*.
3. **Non-Designated Beneficiaries** are any beneficiary that is not a designated beneficiary is a non-designated beneficiary. This includes charities, estates, and trusts that fail as see-through trusts. *Non-designated beneficiaries must liquidate the account by the end of the fifth year after the year of the owner's death.*

***In the year of death, be sure that if the deceased IRA owner was required to take a RMD and did not, that one is made in that year!***

**Is the traditional or Roth IRA better?** It depends on your situation and belief about where tax rates may be headed. Below are some considerations:

* Determine your current marginal income tax bracket and where it may be later in retirement.
* If saving tax dollars today is more important to you than later, then you may want to consider the traditional IRA.
* If you are not eligible for a deductible traditional IRA contribution, or if you are in a lower marginal tax bracket today than you might expect to be in the future, then you may want to consider the Roth IRA.
* Income tax and estate planning considerations include comparing your highest marginal tax bracket compared to your heirs.
* Consideration for Roth IRA conversions when in lower tax brackets.
* How does each IRA fit into your overall retirement income plan?
* Future rising tax risk coupled with Required Minimum Distributions (RMDs) requires careful consideration of each person’s situation and objectives and should motivate investors to consider after-tax Roth contributions (non-tax deductible) to their retirement plans, if available, as well as other taxable accounts (individual, Joint, or Trust) that may allow for attractive tax planning options in our later years.

**Tax Planning.** Having various IRAs and other investment accounts can help us plan with more options in designing our retirement income for tax efficiencies. ***Having only pre-tax/tax-deductible IRAs can create tax bombs later, especially at the RMD age when distributions must come out at future unknown tax rates.***

***Example - Pre-tax accounts only:*** If someone has only tax-deductible/pre-tax IRAs and 401(k)s and earns $100,000 per year in income and plans to retire with living expenses of $100,000, they will not be able to reduce their marginal income tax rates because the pre-tax IRA distributions for income will be 100% taxable just like their pre-retirement income (paychecks) keeping them in the same marginal income tax bracket.

***Example - Pre-Tax and After-tax accounts***: If someone has both pre-tax IRA accounts as well as after-tax and taxable accounts, they may be able to take distributions from their tax-efficient taxable accounts and possibly drop their marginal income tax bracket down to lower brackets that may provide numerous tax planning strategies including being able to covert some the pre-tax IRAs to Roth IRAs at lower income tax rates. The optimal time to do so may be in early retirement when the 100% taxable salaries stop and before starting Social Security, since up to 85% of Social Security benefits may be taxable, and before age 72 when Required Minimum Distributions begin.

***It is important to note that all IRAs and other investment accounts can utilize the same investment (CD, mutual fund, brokerage account, managed account, and annuities in most cases). It is the account title (Individual, Joint, IRA, Roth IRA, trust, etc.) that determines the taxation of the account, not the underlying investment used.***

**IRA Comparison Table**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Traditional IRA** | **Roth IRA** | **Inherited IRAs** **(Traditional & Roth)** |
| Contributions | Pre-tax/Tax-deductible or After-tax  | After-Tax/Non-tax-deductible only  | n/a |
| Saver’s Credit eligibility on contributions | If Eligible | If Eligible | n/a |
| Rollover – custodian to custodian (Direct) | Unlimited times | Unlimited times | Unlimited times |
| Rollovers – to owner & then rollover (Indirect) | 1 per 12-month consecutive period. Must be completed within 60 days | 1 per 12-month consecutive period. Must be completed within 60 days | 1 per 12-month consecutive period. Must be completed within 60 days |
| Tax-deferred | Yes | Yes | Yes |
| Taxation of Distributions | Taxable for Pre-tax contributions.Apply Pro-Rata Rule for After-tax contributions. | Tax-Free if Qualified2If Nonqualified, see Ordering Rules on Pg. 4 | Depends on the Type and, for Roth, if the 5-year rule was met.2 |
| Required Minimum Distributions1 | Yes | Not during the owner's lifetime | Yes3 |
| Can like accounts Combined | Yes, for the same owner | Yes, for the same owner | Yes, for the same owner and the same deceased previous owner only |
| It can be converted to a Roth IRA | Yes | n/a | No |

1. Required Minimum Distributions (RMDs) are required to begin at age 72 (age 70 ½ for those who were 70 ½ on January 1, 2020). RMDs are not required from 401(K) plans if the participant is still employed with that 401(k)-company sponsor. Roth IRAs DO NOT have RMDs, but Roth 401(k) plans Do!
2. Qualified distributions from Roth accounts must meet two criteria; 1) the Participant must be over age 59 ½ AND 2) the account must have been established for five years.
3. Required Minimum Distributions as per page 5.

**Other Tax and Estate Planning Considerations**. Having various investment accounts taxed differently can present attractive tax and estate planning options based on a person’s personal situation, goals, and objectives.

Tax-efficient retirement income design can also help to reduce the taxation on Social Security and Medicare premiums which are determined by looking back years at our MAGI for that year. If our MAGI is one dollar over the bracket, Medicare premiums are increased for that year.

Also, if leaving a legacy to your family or entities is important, there are various ways to do so tax efficiently by utilizing these various IRAs and other investments and comparing your heir’s marginal tax rate to yours.

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**Top 10 IRA Mistakes:**

1. **Not taking a Required Minimum Distribution (RMD) from a traditional IRA.**
2. **Treating Spousal IRAs as their own when surviving spouse is under age 59 1/2.**
3. **Doing more than one indirect rollover in a 12 consecutive month period.**
4. **Not making Roth IRA contributions when eligible to do so.**
5. **Not doing Roth IRA conversions when in very low marginal tax brackets.**
6. **Being too conservative in Roth IRA accounts.**
7. **Not taking advantage of Retirement Saver’s Credit.**
8. **Not having proper beneficiaries listed.**
9. **Not understanding the impact of taxable distributions or Roth IRA conversions impact to Social Security taxation and to Medicare premiums.**
10. **Not taking the RMD from Inherited IRAs when the deceased owner was required to but did not in the year of death.**

***In conclusion, remember it this way—pre-tax/tax-deductible retirement accounts provide tax*** ***savings on the dollar contributions (seeds), but the harvest/distributions from these plans will be 100% taxable. Roth contributions and conversions (seeds) are made with after-tax dollars, but qualified Roth distributions (harvest) can be 100% tax-free.***

Having both IRAs as well as other non-retirement investment account types may provide the best option for tax-efficient planning!

Forward-thinking is good planning!

1. “Value of retirement assets in U.S. 1995-2021, by type,” Statista.com, August 5, 2022. [↑](#footnote-ref-1)