Tax-Deferred Accounts

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We are now at year-end, which concludes the 2022 Wealth Series. This month's focus is around tax-deferred account types.

To enjoy this conversation in full, a link to a replay of our call on this topic can be found here. Below is a writeup of the highlights from our discussion.

Specifically, we covered the basic types of tax-deferred savings plans and accounts, some recent changes to the laws that influence how we utilize these tax-advantaged accounts in our retirement planning, and a few things to keep in mind when incorporating these accounts into your financial and estate plans.

This all stems from the realization that the most consistent costs to an investor come in the form of taxes — long-term capital gains, short-term capital gains or ordinary income. Although, incorporating a variety of tax-efficiencies into your overall strategy and planning can reduce or avoid potential income tax exposure and consequently increase potential investment returns.

These tax efficiencies are generally achieved by utilizing "tax-deferred" or "tax-exempt" accounts, such as IRAs or 401(k)s. Tax-deferred accounts, in general, provide an upfront income tax break (or "deferral") to the investor. That is, the investor may postpone, delay or defer making income tax payments to the IRS until a later date (for example, the investor's retirement age).

Alternatively, tax-exempt accounts can generally be income tax-free or tax-neutral to the investor. Some assets can even be classified as “tax-efficient” because they trigger fewer capital gains (in the case of exchange traded funds or “ETFs”) or because the interest income isn’t taxable either at the federal or state and local levels (which is the case of municipal, Treasury and Series I savings bonds).

IRAs and 401(k)s can also be organized as either “Traditional” or “Roth” accounts. If you have the option and are eligible, you can choose one or a combination of these two types. The primary difference between the two comes down to when you pay income taxes (that is, pay now or pay later) and what you pay taxes on. For traditional accounts, contributions are made “pre-tax,” so you get an up-front tax break in the form of lower taxable income today, but you will pay taxes later upon withdrawal on both the contributions and growth (and hence, the tax advantage to traditional accounts is “tax-deferral”). For Roth accounts, your contributions are made from funds that have already been income-taxed (that is, your net income), so you get no tax break now, but you do not pay taxes in the future upon withdrawal, which means that the tax advantage to a Roth account is “tax-exemption”.

Another item to keep in mind is that contributions to a traditional IRA may be tax-deductible, which could decrease your annual taxable income.

Additionally, if you are not already covered by a retirement plan at work, then you are permitted to take a full deduction on your income tax return up to the amount of your contribution limit. However, your modified adjusted gross income affects the amount of your deduction if you and/or your spouse is covered by a retirement plan at work. And, please note that this deduction is not available for contributions to traditional 401(k)s, Roth IRAs and Roth 401(k)s.

We also discussed some recent changes in the laws that govern these retirement accounts.

At the end of 2019, the Setting Every Community Up for Retirement Enhancement (or “SECURE”) Act was enacted. A provision in the SECURE Act effectively eliminated the “stretch IRA,” an estate-planning strategy that allowed an IRA to benefit from tax-deferred growth, potentially for decades. Individuals who plan to leave IRA and retirement plan assets to heirs — and individuals who stand to inherit retirement assets — should understand the new rules and distribution options.

For retirement assets inherited before 2020, a non-spouse beneficiary had to begin their RMDs within a certain time frame after inheriting the account. However, annual distributions could be calculated based on the beneficiary’s life expectancy. This ability to stretch (or defer) any taxable distributions over a lifetime helped reduce the beneficiary’s annual tax burden and allowed large IRAs to continue benefiting from potential tax-deferred growth.

Next, we delved into two commonly used terms in retirement planning – conversions and rollovers.

In general, you can transfer all or a portion of your traditional IRA funds to a Roth IRA. Anyone can convert a traditional IRA to a Roth IRA in 2022. There are no income limits or restrictions based on your tax filing status. You generally must include the amount you convert in your gross income for the year of conversion, but any nondeductible contributions you've made to your traditional IRA won't be taxed when you convert.

Alternatively, the term "rollover IRA" generally refers to an IRA that you establish to receive funds from an employer retirement plan like a 401(k).

If you choose this method to transfer funds, you must comply with federal rules governing IRA rollovers. For example, if you roll over funds from a previous employer's 401(k) to a newly established rollover IRA, the funds must be deposited in the rollover IRA within 60 days after you receive the distribution from the former employer's 401(k). If you do not meet the 60-day deadline, you may be subject to tax consequences and a penalty. There is no limit on the number of rollovers from traditional IRAs to Roth IRAs that you can make in a year.

To avoid any missteps, we suggest that it is best practice to request that the custodian of your former employer's 401(k) make the transfer directly to the custodian of your newly established Rollover IRA.

Lastly, these accounts and assets are one of the most common, and often some of the higher-value assets included in a decedent's estate. While these assets are generally considered "non-probate" assets (meaning they pass according to a separate beneficiary designation instead of under a Will or a Trust), your Will and/or your Trust must nonetheless be diligently drafted to ensure that any potential estate taxes are properly apportioned in accordance with your wishes (which should include the payment methodology for any such estate taxes that are owed based on the value of your tax-deferred or exempt accounts, as well as the authority of your executor or trustee to recover that portion of your estate taxes triggered by the value of your tax-deferred or exempt accounts from your designated beneficiaries).

We are excited for the 2023 Wealth Series and will continue providing insightful information intended to help improve your financial wellbeing.

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