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Secrets That Your Retirement Advisor Won't Tell You

# Retirement Plans

## The Guide for the Business Owner with No Employees

An Exclusive Special Report from
**cdaaccounting.com**

# Table of Contents

# SEP IRA vs Solo 401(k): Which Should You Choose?

How do you multiply your net worth?

Let the government help.

Here's how: with both the SEP IRA and the solo 401(k) retirement plans, your investment in your tax-favored retirement

- creates tax deductions for the money you invest in the plan,
- grows tax-deferred inside the plan, and
- suffers taxes only when you take the money from the plan.

**Example.** You invest $1,000 a month in your retirement. You are in the 40 percent tax bracket (combined federal and state), and you earn 10 percent on your investments. At the end of 30 years, you have $1.58 million in after-tax spendable cash, which comes from (in round numbers):

- $1.2 million in after-tax cash from the retirement plan ($2 million gross less 40 percent in taxes—we're taking the entire amount out of the plan in this example)
- $380,000 in the side fund (created by investing the $400 of monthly tax savings—$1,000 deduction x 40 percent)

If you had no government help on the taxes and invested $1,000 a month in an investment that earned 10 percent (6 percent after taxes), you would have a little more than $950,000.

**Winner.** The retirement plan wins by $630,000—after taxes ($1.58 million vs $950,000).

Okay, that's the big picture. It tells you that tax-advantaged investing multiplies profits. So, do it.

## Which Plan Is Best for You?

When it comes to picking a retirement plan, you have many choices. If you have no employees in your business, none of the choices are bad. Let's start there and say you have no employees.

And let's say further that you are going to choose between the SEP IRA and the solo 401(k).

**Planning point.** As a one-person business, you can operate as a C or S corporation, single member-LLC, or proprietorship and have either the SEP IRA or the solo 401(k).

## Ease of Setup

The SEP IRA option is easier to set up—but there's no rocket science required to establish a 401(k) plan.

You do have to pay attention to the solo 401(k) requirements, as they can change, but in general, your trustee is going to help you stay in compliance.

## Form 5500

But one filing requirement you need to pay attention to is that once your 401(k) account reaches $250,000 in assets, you must file Form 5500 with the IRS each year.[1] And your trustee likely does not do this for you. Further, you may not have engaged your tax preparer to help with this.

Beginning with tax years 2020 and later, the IRS has made the Form 5500 EZ mandatory for use by the solo 401(k) with $250,000 or more in assets, and it's available for either online or paper filing.[2]

The SEP rules do not require you to file Form 5500.

## Why Choose a Solo 401(k)?

There are reasons to choose a solo 401(k). For one, if your goal is to stash away as much cash as possible, then a solo 401(k) may be an option worth looking into—especially if your income is on the smaller side.

With a solo 401(k), annual deductible contributions to the business owner's account can come from two sources.

## Source 1 (You): Elective Deferral Contributions

For 2022, you can contribute to your solo 401(k) account up to $20,500 ($27,000 if age 50 or older) of[3]

- your W-2 income if you are employed by your own C or S corporation, or
- your net self-employment income if you operate as a sole proprietor or as a single-member LLC that's treated as a sole proprietorship for tax purposes.

## Source 2 (Your Business): Employer Contributions

On top of your elective deferral contribution, the solo 401(k) arrangement permits an additional employer contribution of up to 25 percent of your corporate salary or 20 percent of your net self-employment income.

For purposes of calculating the employer contribution, your compensation or net self-employment income is not reduced by your elective deferral contribution.[4]

- With a corporate plan, your corporation makes the employer contribution on your behalf.
- With a plan set up for a sole proprietorship or a single-member LLC, you are effectively treated as your own employer. Therefore, you make the employer contribution on your own behalf.[5]

## Strange, But True

Note that the one-person business is both an employee and an employer for the solo 401(k).

## SEP IRA Has One Leg

With the SEP, you look at the employer contribution only—which is up to 25 percent of your W-2 wages if you operate as a corporation or 20 percent of your self-employment income, as adjusted.[6]

## Comparison Example

Brayden Stout earns $19,000 from freelance work performed as an independent contractor.

- Under the solo 401(k) rules, Brayden could contribute almost all of this $19,000 in net earnings to a solo 401(k).
- Under the SEP IRA rules, he could contribute only about $3,800 ($19,000 x 20%).

## High Income

If you are **under age 50** and your income is on the higher side, the 2022 ceiling on contributions is $61,000.

But if you are **age 50 or older**, the solo 401(k) has a catch-up provision that allows you to contribute another $6,500, creating a maximum 2022 potential of $67,500.[7]

The SEP IRA does not allow a catch-up contribution.

**Planning point.** The 401(k) catch-up contribution must come from an employee deferral.

**Example.** Sam Jones, age 53, operates a very profitable C corporation that pays him a big W-2 wage. The C corporation contributes $61,000 to Sam's 401(k). That's the employer's maximum—the lesser of $61,000 or 25 percent of Sam's W-2 wages. Sam may make an employee elective deferral of $6,500 that reduces his taxable income for the year and adds to his retirement fund, making $67,500 ($61,000 + $6,500) the total contributions to his solo 401(k) for the year.

## Key Comparison

The SEP IRA contribution can be made only by the employer—employee contributions are not allowed! The solo 401(k) plan allows both employer and employee contributions.

**Example.** Rose Rice, a self-employed engineer under the age of 50 has an annual profit of $120,000.

- With the SEP IRA, Rose can contribute a maximum of $22,304.
- With the solo 401(k), Rose can contribute a maximum of $42,804 ($20,500 as an employee and $22,304 as the employer).

## Takeaways

The key to big retirement plan savings is to start early and invest well.

And of course, the more money you can invest well, the more your retirement nest egg grows.

You have several retirement plan options. In this article, we made a comparison for the business owner with no employees other than him or herself (if incorporated) and the SEP IRA with the solo 401(k) and offered the following insights:

- A SEP IRA is typically easier and cheaper to set up than a solo 401(k).
- With the solo 401(k), you have to file form 5500EZ once your plan assets exceed $250,000.
- In most cases, the owner of a one-person business can sock away more money for retirement with the solo 401(k) than with the SEP IRA because the solo 401(k) allows both the employee elective deferral and the employer contribution.

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[1] IRS Publication 560, Qualified Plans (2020), Dated Mar. 1, 2021, p. 21.

[2] Instructions for Form 5500-EZ (2020), p. 2.

[3] IR 2021-216.

[4] IRC Section 404(n).

[5] IRC Section 402(i).

[6] IRS Publication 560, Simplified Employee Pensions (SEPS) (2020), Dated Mar. 1, 2021, ps. 6, 14, 23, and 24.

[7] IRC Section 414(v); Notice 2021-61.

# Why a SIMPLE-IRA Could Be Your Best Retirement Plan Alternative

A SIMPLE-IRA could be your best retirement plan option if your business generates only a modest amount of annual income.

You must have your SIMPLE-IRA set up by October 1, 2022, to permit a deductible contribution for your 2022 tax year.

Here's what you need to know about the often-underappreciated SIMPLE-IRA small business retirement plan alternative.

## SIMPLE-IRA Basics

For the one-person operation that generates only a modest amount of annual income, the SIMPLE-IRA is often the best tax-favored retirement plan choice.

Self-employed individuals can set up SIMPLE-IRAs. So can one-employee corporations and other employers with up to 100 workers. For this purpose, only employees who earned at least $5,000 during the previous year are counted.

## Deductible Contributions

For 2022, you can contribute up to the lesser of

- 100 percent of self-employment income or corporate salary, or
- $14,000.

This is considered to be an elective deferral contribution made to your SIMPLE-IRA account by you as a self-employed individual or by you as an employee of your own corporation.

Then the employer makes a matching contribution equal to the lesser of (1) 3 percent of your self-employment income or salary, or (2) the amount of your elective deferral contribution.

When you run your business as a sole proprietorship or as a single-member LLC treated as a sole proprietorship for tax purposes, you make the employer matching contribution, as well as the elective deferral contribution, on your own behalf.

When you are employed by your own C or S corporation, the company makes the employer matching contribution to your account. The elective deferral contribution is withheld from your salary.[1]

## SIMPLE-IRA Contribution Advantage Illustrated

The following examples quantify the SIMPLE-IRA deductible contribution advantage for a business that generates modest annual income.

### Example 1: Corporate Business

You are employed by your own C or S corporation (the results are the same either way). You receive a $30,000 salary for the year. You contribute the maximum $14,000 to your SIMPLE-IRA as an elective deferral contribution. That reduces your taxable salary from $30,000 to $16,000 for federal income tax purposes.

You then direct your corporation to make a matching deductible employer contribution of $900 (3 percent x $30,000). So, the elective deferral and employer contributions add up to a total of $14,900 of tax-saving deductions. Nice!

In contrast, if you had a simplified employee pension (SEP) arrangement or a profit-sharing plan, the maximum deductible contribution to your account would be only $7,500 (25 percent x your $30,000 salary).

### Example 2: Sole Proprietorship

You run your shop as a sole proprietorship or as a single-member LLC treated as a sole proprietorship for tax purposes. You have $30,000 of net self-employment income for the year. You contribute the maximum $14,000 to your SIMPLE-IRA and claim a $14,000 deduction on your Form 1040.

You then make a matching employer contribution of $900 (3 percent x $30,000) and deduct another $900 on your Form 1040. The combined tax-saving deductible contributions add up to $14,900.

In contrast, the maximum deductible contribution would be only $6,000 (20 percent x $30,000) with a self-employed SEP or a defined contribution Keogh plan.

## Extra Catch-Up Contributions If You Are Age 50 or Older

If you are age 50 or older as of December 31, 2022, you can make an additional *catch-up* elective deferral contribution of up to $3,000 for 2022.[2]

So, if you are age 50 or older at year-end, the maximum 2022 elective deferral contribution, including the extra catch-up contribution, is $17,000 ($14,000 + $3,000).

Example 3: Catch-Up Contributions

You earn $30,000 of self-employment income or salary from your corporation and are age 50 or older as of year-end. You can contribute up to $17,900 to your SIMPLE-IRA ($14,000 regular elective deferral contribution + $3,000 extra catch-up contribution + $900 employer matching contribution).

In contrast, the maximum deductible pay-in to a self-employed SEP or defined contribution Keogh plan would be only $6,000 (20 percent x $30,000). The maximum deductible contribution to a corporate SEP or profit-sharing plan would be only $7,500 (25 percent x $30,000).

## SIMPLE-IRA Pros

When your business produces only a modest amount of annual income, the SIMPLE-IRA arrangement can permit much healthier annual deductible contributions to your account, as the preceding examples illustrate.

Also, SIMPLE-IRA elective deferral contributions are completely discretionary. If you decide not to make an elective deferral contribution for the year, you need not make any employer matching contribution either. So, you can limit contributions to very minimal amounts, or even nothing at all, in years when cash is tight. Flexibility is good!

Finally, with a SIMPLE-IRA, there is no requirement to file any annual reports with the federal government.[3] Yay!

## SIMPLE-IRA Cons

The SIMPLE-IRA is *not* the best choice if your business produces healthy annual self-employment income or a healthy annual corporate salary for you. In that scenario, other types of plans, such as a SEP, solo 401(k) plan, or defined benefit pension plan, can permit larger annual deductible contributions to your account.

You must establish your SIMPLE-IRA by no later than October 1 of the year for which the initial deductible contribution will be made.[4] For example, you must set up your SIMPLE-IRA by October 1, 2022, to make a deductible contribution for the 2022 tax year.

**Note.** The SECURE Act modification that allows qualified plans to set themselves up retroactively for the prior year does not apply to the SIMPLE-IRA.

## Employees

With a SIMPLE-IRA plan, you may have to make employer matching contributions for other employees (beyond just yourself as the owner), and those contributions are immediately 100 percent vested.

Specifically, all employees who earned $5,000 or more during any two previous years (whether or not consecutive) and who are reasonably expected to earn at least $5,000 in the current year must be allowed to participate in the SIMPLE-IRA plan.[5]

But if you don't have any employees who meet that description, you can establish a SIMPLE-IRA that benefits only you.

Finally, you cannot borrow from a SIMPLE-IRA account. In contrast, you can borrow against other types of retirement plan accounts (assuming the plan document so permits), except for SEPs.[6] SIMPLE-IRAs and SEP accounts are considered IRAs, and borrowing from an IRA is a tax-law no-no.

## Can You Also Contribute to a Traditional or Roth IRA If You Have a SIMPLE-IRA?

Yes, but the SIMPLE-IRA is considered an employer-sponsored retirement plan, so the privilege of making deductible contributions to a traditional IRA is subject to the usual income limitations that apply to participants in employer-sponsored retirement plans.

## How to Set Up a SIMPLE-IRA

Most major brokerage firms will set up SIMPLE-IRAs for minimal or no fees. As stated earlier, you must set up a SIMPLE-IRA plan by October 1 of the year in question to accept deductible contributions for that year.

## Takeaways

When your business generates a modest amount of self-employment income or salary from your corporation and there are no other employees who must be covered, the SIMPLE-IRA is probably the best retirement plan choice, because it offers the opportunity to make bigger annual deductible contributions.

The bigger contribution is even bigger if you are age 50 or older, because you can then make additional elective deferral catch-up contributions.

Keep this in mind: SIMPLE-IRAs are *simple,* and simple is good!

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[1] IRC Section 408(p) 2018.

[2] IRC Section 414(v)(2)(B)(ii).

[3] IRC Section 408(l)(2) 2018.

[4] IRC Section 408(p)(6)(C) 2018.

[5] IRC Sections 408(p)(3) 2018; 408(p)(4) 2018.

[6] IRC Sections 408(e) 2018; 4975(c)(1)(B); 4975(d)(1); 4975(f)(6).

# The Defined Benefit Pension Plan

Defined benefit pension plans can allow big annual deductible contributions if you are approaching middle age or are already there.

Before getting into details, here is an alert: Annual contributions to defined benefit plans are mandatory. Thus, in good times or bad, you have to pay the required annual amount.

The previous articles discussed defined contribution plans where contributions are discretionary, allowing you to contribute little or nothing in years when cash is tight.

Thus, defined benefit plans have two key distinctions:

1. Required annual contributions
2. Possible bigger funding of your retirement

## Defined Benefit Plan Basics

The defined benefit arrangement promises the plan participant(s) (you and other workers you must cover, if any) a "target" annual retirement check beginning at retirement age. In defining the target, you have the following options:

- Fixed percentage of income
- Flat monthly dollar amount
- Formula based on years of service

The percentage-of-income option is based on an average of self-employment or salary income depending on your business model. You can define the average as income over your entire career or over a certain number of years near the end of your career.

Once you define the retirement income promise, you personally, if you are self-employed, or your corporation, if you are employed by your own C or S corporation, make annual deductible contributions to the plan in amounts sufficient to fund the target retirement payouts.

If self-employed, you claim the deductions on your personal return.

If you operate as a corporation, the corporation claims the deductions on its return.

In what is an added expense for the defined benefit plan, you engage an actuary to compute the required annual contributions based on:

- the remaining years to retirement,
- the expected rate of return on investments held in the plan,
- the promised level of annual benefits, and

- the plan’s current balance.

## Why the Defined Benefit Plan?

The defined benefit plan fits the high earner who is creeping up on retirement age and wants to fund a hefty retirement check of up to $245,000 annually (2022 limit)[1].

## Advantage 1: Big Deductions (Big Funding)

The high earner age 50 or older finds that the defined benefit pension plan allows larger annual deductible contributions (maybe $100,000 or more) than other retirement plan alternatives.

## Advantage 2: Late Funding

You can make the required annual contribution to the defined benefit plan any time up to the due date of the tax return, including extensions, for the year you claim deductions. Thus, sole proprietors can make their 2022 contributions as late as when they file their extension in October 2023.[2]

## Disadvantage 1: Professional Assistance

Unlike plans where you define the contribution and everything is nice and straightforward, you need to spend money on an actuary to define the funding you need in order to produce the defined retirement benefit.

Also, unlike defined contribution plans where you face few tax-law change difficulties, your defined benefit plan often faces tax law changes that require professional assistance and increase your costs.

**Much better than before.** In years past, costs associated with defined benefit plans often made them ill suited for all but the most well-heeled small businesses. Today, commoditization of small-business defined benefit plans by major brokerages and insurance companies has made defined benefit plans more readily available.

## Disadvantage 2: Mandatory Funding

Unlike defined contribution plans, your defined benefit pension plan must be funded. Funding failures trigger an excise tax of 10 percent of the deficiency for each year that the deficiency exists.[3] But if the deficiency is not cured by the end of the year, the minimum penalty is increased to 100 percent of the deficiency.[4]

## Disadvantage 3: Covering Employees

If you hire employees then you must consider the employees in the defined benefit pension plan.

The law allows you to exclude from coverage any employees under age 21 and those who have not worked at least 1,000 hours for your business during any 12-month period.[5]

Your plan design becomes important as you insert employees. The existence of employees does not necessarily destroy your possible benefits from the defined benefit plan, but employees certainly trigger the need for planning.

## The Big Picture

You should consider the defined benefit plan if

- you have a business that generates healthy profits,
- you are around age 50 or older, and
- you have and expect to continue to have the cash to make the required contributions.

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[1]IRC Sections 404(a)(1); 404(a)(8); 415(b).; IRC Section 415(b)(1)(A); Notice 2021-61.

[2]IRC Section 404(a)(6).

[3]IRC Section 4971(a)(1).

[4]IRC Section 4971(b)(1).

[5]IRC Sections 410(a)(1)(A); 410(a)(3)(A).

# Roth IRA versus Traditional IRA: Which Is Better for You?

Roth IRAs tend to get a lot of hype, and for good reason: Because you pay the taxes upfront, your eventual withdrawals (assuming you meet the age and holding-period requirements—more on these below) are completely tax-free.

While we like "tax-free" as much as the next person, there are more times than you would imagine when a traditional IRA will put more money in your pocket than a Roth would.

## Limits

For 2022, the combined contribution limit for both traditional and Roth IRAs is the lesser of $6,000 ($7,000 for age 50 and over) *or* your taxable compensation for the year.[1]

### Making the Decision on What's Best

**Example.** Say that your tax rate is 32 percent and that you will invest $5,000 a year in an IRA and earn 6 percent interest. Should you put the $5,000 a year into a Roth or a traditional IRA?

Say further that neither you nor your spouse is covered by a workplace retirement plan, so you can contribute the $5,000 a year without worry because it's under the contribution limits.[2]

## Traditional IRA

If you invest the $5,000 in a traditional IRA, you create a side fund of $1,600 ($5,000 x 32 percent).

On the side fund, you pay taxes each year at 32 percent, making your side fund grow at 4.08 percent (68 percent of 6 percent).

## Roth IRA

Roth contributions are not deductible; this means no side fund, so your annual investment remains at $5,000.

## Cashing Out

For the Roth, your marginal tax rate at the time of your payout doesn't matter because you paid your taxes *before* the money went into the account. The whole amount is now yours, with no additional taxes due.

But for the traditional IRA, your current tax bracket matters a great deal. You have taken care of the taxes on the side fund annually along the way, but the traditional IRA (both growth and contributions) is taxed at your current marginal tax rate at the time you cash out.

The table below shows you how this looks with tax rates of 22 percent, 32 percent, and 37 percent at the time you cash out (winners are in bold):

| Marginal tax rate at cash-out | 10 years @ 6%[3] | 20 years @ 6% | 30 years @ 6% | 40 years @ 6% |
|---|---|---|---|---|
| **22%** | **Trad: $74,557**[4]<br>Roth: $69,858 | **Trad: $202,074**<br>Roth: $194,964 | **Trad: $421,482**<br>Roth: $419,008 | Trad: $801,048<br>**Roth: $820,238** |
| **32%** | Trad: $67,571<br>**Roth: $69,858** | Trad: $182,578<br>**Roth: $194,964** | Trad: $379,581<br>**Roth: $419,008** | Trad: $719,024<br>**Roth: $820,238** |
| **37%** | Trad: $64,079<br>**Roth: $69,858** | Trad: $172,830<br>**Roth: $194,964** | Trad: $358,630<br>**Roth: $419,008** | Trad: $678,012<br>**Roth: $820,238** |

You can see that the traditional IRA needs a low tax rate at the time of cash-out to win. But even in the 22 percent cash-out tax rate, the Roth wins at the 40-year mark.

## Rate of Growth

What about your rate of growth? Do variances here change things any? Let's take a look.

Here, we'll look at different rates of growth for a fixed period (30 years) before you withdraw your money. Once again, we'll consider three different marginal tax rates at the time you cash out—22 percent, 32 percent, and 37 percent.

| Marginal tax rate at cash-out | 3%[5] for 30 years | 6%[6] for 30 years | 9%[7] for 30 years | 12%[8] for 30 years |
|---|---|---|---|---|
| **22%** | **Trad: $257,760**<br>Roth: $245,013 | **Trad: $421,482**<br>Roth: $419,008 | Trad: $716,547<br>**Roth: $742,876** | Trad: $1,256,032<br>**Roth: $1,351,463** |
| **32%** | Trad: $233,259<br>**Roth: $245,013** | Trad: $379,581<br>**Roth: $419,008** | Trad: $642,260<br>**Roth: $742,876** | Trad: $1,120,886<br>**Roth: $1,351,463** |
| **37%** | Trad: $221,008<br>**Roth: $245,013** | Trad: $358,630<br>**Roth: $419,008** | Trad: $605,116<br>**Roth: $742,876** | Trad: $1,053,312<br>**Roth: $1,351,463** |

In the scenarios above, the traditional IRA/side fund combo wins only when your marginal tax rate is lower at the time of withdrawal *and* only at the lower growth rates.

At higher rates of return—9 percent and 12 percent, in our examples above—the Roth still wins, even if you're in a higher tax bracket when you withdraw your money.

## Tax Factor

What's going on here?

For starters, the side fund is not tax-favored in any way.

Plus, taxes hobble your cash-out on the traditional IRA:

- You pay taxes as you earn the money in the side fund.
- You pay taxes on the accumulated growth inside the traditional IRA when you withdraw the money.

## Look into the Crystal Ball

What tax bracket will you be in years or decades from now?

Unfortunately, there's no way to know for sure. Nobody can predict what the federal government will be doing, tax-wise, down the line—though we do think it's a safe bet that federal income taxes will not be abolished!

A better strategy is to look at your individual tax situation. While, again, nothing is certain, you may be able to anticipate likely life events—such as retirement, kids leaving home, mortgage paid off—that will affect your time of investment and tax bracket one way or the other.

The length of time you plan to keep the investment matters. As we see in the first table, given enough time, the Roth eventually catches up and passes the traditional IRA, even if your tax bracket is lower at the time you cash out.

Similarly, there's no way to be sure what rate of growth you're going to get over several decades of investing. A very rough (but common) benchmark is a 10 percent return, pre-tax[9]—which, again, tends to favor the Roth in our example above.

## But Wait! There's More…

Setting aside for the moment the Roth advantages we've discussed above, a Roth offers other additional perks.

**No required minimum distributions (RMDs).** When you have a traditional IRA, the IRS requires you to start taking distributions by April 1 following the year you turn 72, and by December 1 in subsequent years.

The withdrawals are (a) mandatory and (b) included in your taxable income, with the exception of basis.[10] Because there is no RMD requirement with a Roth, it's an excellent vehicle for continuing to grow your wealth and, if you so desire, passing it on to your children.

**Longer period to contribute.** Not only do you have to start taking RMDs when you hit 72 with a traditional IRA—but you're also barred from making additional contributions when you hit that magic age.

With a Roth, you may contribute at any age, as long as you have taxable compensation. (There are income limits[11] for Roth contributions, but you can get around these using the backdoor strategy.)

**More flexibility with withdrawals.** You can withdraw your contributions to a Roth anytime, without penalty. And if you're over age 59½, distributions of earnings from your Roth are also not taxable—because, again, you paid the taxes up front.

You just need to satisfy the five-year waiting period requirement, meaning the distribution must occur after the five-year period starting with the first taxable year for which a contribution was made to the Roth.[12] With a traditional IRA, both deductible contributions and earnings are taxed at the time of withdrawal.

## Traditional IRA Advantages

Is there ever a time a traditional IRA would be better? Maybe. Here are two possible reasons.

**1. Lowers your taxable income at the time of contribution.** Because contributions to traditional IRAs are generally deductible, they reduce your taxable income at the time you make them.

If you're in a high tax bracket now, or if you're looking for a last-minute deduction, this may be something worth considering. But remember—you need to invest that money in the side fund to have even a crack at coming out ahead with the traditional IRA.

If your plan is to blow the tax savings on doughnuts, you're better off with a Roth.

**2. State income tax considerations.** If you live in a state that charges high income taxes, but you could see yourself moving in the future to a state with lower (or zero) income taxes, a traditional IRA could let you defer those taxes—and possibly avoid them entirely in case of a move.

Different states have different laws on the deductibility of IRA contributions as well as on the taxation of retirement plan distributions, so make sure you're clear on the rules in both your current and future locations.

## Takeaways

Roth IRAs offer a lot of tax advantages for your future self, while traditional IRAs give you the tax breaks *now*. The trade-off is an uncertain tax liability decades from now, possibly after you've stopped working.

And given enough time and/or a high rate of return, you're better off with a Roth anyway.

If you really want the current deduction, a traditional IRA may make sense. It may also be a good choice if you anticipate moving from a high-income-tax state to a more tax-friendly locale.

But remember—you must actually invest the side fund money to create even a fighting chance for your traditional IRA to tie or beat a Roth. Don't take your deduction and blow the tax savings on doughnuts.

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[1] Notice 2021-61.

[2] IRC Section 219(a).

[3] Remember, a 6 percent rate of growth is actually only 4.8 percent for the side fund, post-tax.

[4] All the totals for the traditional IRA, in both tables, represent the sum of the post-tax IRA amount plus the side fund amount.

[5] 2.04 percent, post-tax, for the side fund.

[6] 4.08 percent, post-tax, for the side fund.

[7] 6.12 percent, post-tax, for the side fund.

[8] 8.16 percent, post-tax, for the side fund.

[9] See, e.g., this report from the Urban-Brookings Tax Policy Center, FN 16, reported in Tax Notes on August 24, 2018.

[10] IRC Section 72(t)(1).

[11] Notice 2021-61.

[12] IRC Section 408A(d)(2)(B) 2018.

# How Are Roth IRA Withdrawals Taxed?

You may think that all Roth IRA withdrawals are federal-income-tax-free. Not true!

Some withdrawals are taxable.

Even worse, some can be socked with a 10 percent early withdrawal penalty tax, and this can happen even when there's no income tax hit.

Here's what you need to know about Roth IRA withdrawals under the federal income tax rules. We start with the simplest case.

## Rules for Qualified Withdrawals Are Simple

Any withdrawals from any of your Roth accounts are federal-income-tax-free qualified withdrawals if you, as a Roth IRA owner,

- are age 59 1/2 or older, and
- have had at least one Roth IRA open for over five years.

Such withdrawals are usually state-income-tax-free too. Good!

You must pass both the age and the five-year tests to have a qualified withdrawal.[1]

The five-year period for determining whether your withdrawals are qualified starts on January 1 of the first tax year for which you make a Roth contribution.[2] It can be a regular annual contribution or a conversion contribution.

**Example 1. Figuring the earliest date for qualified withdrawals.**

You established your initial Roth IRA (Roth IRA-1) with a regular annual contribution made on April 15, 2018, for your 2017 tax year. Your five-year period started on January 1, 2017, even though you physically made your initial Roth contribution in 2018.

Anytime on or after January 1, 2022, you can take federal-income-tax-free qualified withdrawals from Roth IRA-1, assuming you are age 59 1/2 or older on the withdrawal date.

You opened up a second Roth account (Roth IRA-2) in 2020 with a conversion contribution from a traditional IRA.

You can take tax-free qualified withdrawals from Roth IRA-1 and/or Roth IRA-2 anytime on or after January 1, 2022, assuming you are age 59 1/2 or older on the withdrawal date.

## Tax Reporting for Qualified Withdrawals

When you take a qualified Roth withdrawal, you should receive a Form 1099-R from the IRA trustee or custodian.[3]

Box 1 of the Form 1099-R should report the gross amount of the withdrawal.

Usually, box 2b will be checked to indicate that the trustee or custodian has not determined the taxable amount (if any). But if the trustee or custodian knows the withdrawal was a qualified withdrawal, box 2a should report a taxable amount of zero and box 7 should contain distribution code Q (qualified distribution, meaning it's tax-free).

You enter the total amount of the qualified withdrawal on line 4a of your Form 1040.[4] Enter zero on line 4b, because qualified withdrawals are federal-income-tax-free. Simple!

## Rules for Non-Qualified Withdrawals Are Not So Simple

A non-qualified withdrawal is potentially subject to federal income tax. In addition, non-qualified withdrawals taken before age 59 1/2 are potentially subject to a 10 percent early withdrawal penalty tax.[5]

To make things a bit easier to understand, we will break down non-qualified withdrawals into two scenarios:

1. Withdrawals that are non-qualified because they are taken before age 59 1/2
2. Withdrawals that are non-qualified solely because they are taken before you've passed the five-year test

## Scenario 1: Withdrawal Is Non-Qualified because You Take It before Age 59 1/2

In general, *any* Roth withdrawal taken before you have reached age 59 1/2 is a *non-qualified withdrawal* by definition. The only exceptions are

- when the special first-time home purchase provision (explained later) applies, or
- when the account owner (that would be you) is disabled or dead.

A non-qualified withdrawal is potentially subject to both federal income tax and the 10 percent early withdrawal penalty tax.

Non-qualified withdrawals can potentially come from four different layers. Different federal income tax rules apply to each layer.

**Key point.** If you have several Roth IRAs, you must aggregate them and treat them as a single account to determine which layer or layers each withdrawal comes from and the resulting federal income tax consequences.[6]

**Withdrawals from Layer No. 1 (Annual Contributions)**

Non-qualified withdrawals are deemed to come first from the layer consisting of annual Roth contributions, which we will call Layer No. 1. Withdrawals from this layer are always federal-income-tax-free and penalty-free. (Remember, this is the money you put into the Roth, not the earnings of the Roth.)

To determine how much is in Layer No. 1, combine the annual contributions to all Roth IRAs set up in your name.

To prove that you owe no federal income tax or early withdrawal penalty tax on a non-qualified withdrawal from Layer No. 1, complete Part III of IRS Form 8606 Nondeductible IRAs, and include it with your Form 1040.[7]

Enter the total amount of the withdrawal on line 4a of your Form 1040.[8] Enter zero on line 4b, because withdrawals from Layer No. 1 are always federal-income-tax-free.

**Withdrawals from Layer No. 2 (Taxable Portion of Conversion Contributions)**

After you've exhausted Layer No. 1, additional non-qualified withdrawals are deemed to come from the layer consisting of the *taxable portion* of any Roth conversion contributions, which we will call Layer No. 2.

Conversion contributions can come from converting a traditional IRA into a Roth account or from contributing a retirement plan distribution, such as from a 401(k) account, to a Roth IRA. The taxable portion of a conversion contribution is the amount of gross income that was triggered by the conversion contribution (the total contribution amount minus any non-deductible contributions included in that contribution).

To determine how much is in Layer No. 2, combine all the taxable conversion contributions to all Roth IRAs set up in your name.

While withdrawals from Layer No. 2 are always federal-income-tax-free, you could still get hit with the 10 percent early withdrawal penalty tax. Specifically, the 10 percent penalty tax hits any amount withdrawn from Layer No. 2 within five years of the conversion contribution unless one of the penalty tax exceptions for IRAs is available.

The five-year period is deemed to begin on January 1 of the year during which you made the conversion contribution.[9]

If you made several conversion contributions in different years, use the first-in-first-out (FIFO) principle to determine which contribution the withdrawal comes from for purposes of applying the five-year rule.[10]

To prove that no federal income tax is owed on a non-qualified withdrawal from Layer No. 2, complete Part III of IRS Form 8606 and include it with your Form 1040.[11] If you owe the 10 percent early withdrawal penalty tax, complete IRS Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, and include it with your Form 1040.[12] Enter the penalty tax amount on the appropriate line of Form 1040.

Enter the total amount of the withdrawal on line 4a of your Form 1040. Enter zero on line 4b, because withdrawals from Layer No. 2 are always federal-income-tax-free even though they may be exposed to the 10 percent early withdrawal penalty tax.

**Withdrawals from Layer No. 3 (Non-Taxable Portion of Conversion Contributions)**

After you've exhausted Layer No. 1 and Layer No. 2, additional non-qualified withdrawals are deemed to come from the layer consisting of the *non-taxable portion* of any Roth conversion contributions, which we will call Layer No. 3.

The non-taxable portion of a conversion contribution equals the amount of non-deductible contributions included in that conversion. To determine how much is in Layer No. 3, combine all the non-taxable conversion contribution amounts to all Roth IRAs set up in your name.

Withdrawals from Layer No. 3 are always federal-income-tax-free and penalty-tax-free.

To prove that no federal income tax is owed on a non-qualified withdrawal from Layer No. 3, complete Part III of IRS Form 8606, and include the form with your Form 1040.[13]

Enter the total amount of the withdrawal on line 4a of your Form 1040. Enter zero on line 4b, because withdrawals from Layer No. 3 are federal-income-tax-free.

**Withdrawals from Layer No. 4 (Account Earnings)**

Any additional non-qualified withdrawals come from the layer consisting of Roth IRA earnings, which we will call Layer No. 4.

Non-qualified withdrawals from Layer No. 4 are always 100 percent taxable. Complete Part III of IRS Form 8606, and enter the taxable amount from Layer No. 4 on Line 4b of your Form 1040.[14]

In addition, you'll owe the 10 percent early withdrawal penalty tax on non-qualified withdrawals taken from Layer No. 4 unless one of the exceptions to the penalty tax for IRAs is available.[15]

If you owe the 10 percent early withdrawal penalty tax, complete IRS Form 5329 and include it with your Form 1040.[16] Enter the penalty tax amount on the appropriate line of your Form 1040.

Enter the total amount of the withdrawal on line 4a of your Form 1040. Enter the same amount on line 4b, because withdrawals from Layer No. 4 are always taxable.

**Example 2. Handling an early Roth IRA withdrawal.**

You are currently under age 59 1/2. Back in 2017, you converted your only traditional IRA, which was then worth $60,000, into a Roth IRA. Assume the entire $60,000 was a taxable conversion contribution because you claimed a tax deduction for all the money you put into this IRA.

In April 2019, you made a $5,000 annual contribution to the same Roth account. That contribution was for your 2018 tax year. You have not made any further Roth IRA contributions.

In 2021, you withdraw $30,000. At the time of the withdrawal, your Roth account balance was $100,000. The withdrawal is a non-qualified withdrawal because you are under age 59 1/2.

Under the layering rules for non-qualified withdrawals, the first $5,000 is treated as coming from your annual contribution for the 2018 tax year (Layer No. 1). That amount is federal-income-tax-free and penalty-free.

The remaining $25,000 is treated as coming from the 2017 conversion contribution (Layer No. 2). The $25,000 is federal-income-tax-free. But because the $25,000 was withdrawn within five years of the deemed conversion contribution date (January 1, 2017), it's hit with the 10 percent early withdrawal penalty tax unless you are eligible for one of the exceptions to the penalty tax for IRAs.

**Key point.** Withdrawing from Layer No. 2 within five years of the deemed conversion contribution date is a less-than-great idea unless you are eligible for an exception to the 10 percent early withdrawal penalty tax.

**Example 3. Both income tax and penalty tax can potentially apply to early Roth withdrawals.**

Assume the same basic facts as in Example 2, except this time you withdraw $70,000 in 2021.

As in Example 2, the first $5,000 is deemed to be a federal-income-tax-free and penalty-free withdrawal from Layer No. 1.

The next $60,000 is deemed to come from Layer No. 2. The $60,000 comes out federal-income-tax-free, but you owe the 10 percent early withdrawal penalty tax on the entire $60,000 unless you are eligible for an exception.

The final $5,000 comes from account earnings (Layer No. 4). The entire $5,000 must be reported as taxable income on your 2021 Form 1040 because you are not age 59 1/2, dead, disabled, or using the money for qualified home acquisition costs (see below).

The entire $5,000 is also hit with the 10 percent early withdrawal penalty tax unless you are eligible for an exception.

## Scenario 2: Withdrawal Is Non-Qualified because You Fail the Five-Year Test

Any Roth withdrawal taken after you have reached age 59 1/2 (or died or become disabled) but before you pass the five-year test is a *non-qualified withdrawal* by definition. As such, it's potentially subject to federal income tax and the 10 percent early withdrawal penalty tax.

In Scenario 2, where you fail the five-year test, non-qualified withdrawals are handled under the same four-layer system that applies to Scenario 1 non-qualified withdrawals.

**Key point.** In this failed-the-five-year-test scenario, you are never hit with the 10 percent penalty tax on any withdrawals that are taken after you reach age 59 ½, become disabled, or die.

**Reminder.** If you have several Roth IRAs, you must aggregate them and treat them as a single account to determine which layer(s) each withdrawal comes from and the resulting federal income tax consequences.

## Tax Reporting for Non-Qualified Withdrawals

Just like when you take a qualified withdrawal, when you take a non-qualified Roth withdrawal, you should receive a Form 1099-R from the IRA trustee or custodian.[17] Box 1 of your Form 1099-R should report the gross amount of the non-qualified withdrawal. Usually, box 2b will be checked to indicate that the trustee or custodian has not determined the taxable amount. But if the trustee or custodian knows the taxable amount, it could be reported in box 2a.

Box 7 of Form 1099-R should report distribution code T (exception applies) if the trustee or custodian knows the 10 percent penalty tax is not owed because you were age 59 1/2 or older, disabled, or dead when the non-qualified withdrawal was taken.

Box 7 of Form 1099-R should instead report distribution code J (early distribution) if the trustee or custodian thinks the 10 percent penalty tax is owed.

## Don't Overlook First-Time Home Purchase Exception for Under-Age-59-1/2 Account Owners

Assuming you've passed the five-year test, this exception allows federal-income-tax-free and penalty-free Roth IRA withdrawals to the extent you spend the money within 120 days on *qualified acquisition costs* for a principal residence.

This favorable exception is available even if you are under age 59 1/2. But there's a $10,000 lifetime limit, and you must have passed the five-year test.

To the extent this exception applies, treat the applicable amount as a federal-income-tax-free qualified withdrawal.

Under this exception, the principal residence can be acquired by[18]

1. you, as the Roth IRA account owner, or your spouse;
2. your child, grandchild, or grandparent; or
3. your spouse's child, grandchild, or grandparent.

The buyer of the principal residence (and the buyer's spouse, if the buyer is married) must not have owned a present interest in a principal residence within the two-year period that ends on the acquisition date.[19] Qualified acquisition costs are defined as costs to acquire, construct, or reconstruct a principal residence—including closing costs.[20]

When you take a withdrawal that qualifies for this exception, you should receive a Form 1099-R from the Roth IRA trustee or custodian. Box 1 of the Form 1099-R should report the gross amount of the withdrawal.

Usually, box 2b will be checked to indicate that the trustee or custodian has not determined the taxable amount (if any).

Box 7 may report distribution code J (early distribution) if the trustee or custodian thinks the 10 percent penalty tax is owed because you were not age 59 1/2 or older or disabled or dead when the withdrawal was taken.

For a Roth IRA withdrawal that qualifies for this exception, enter the total withdrawal amount on line 4a of Form 1040.[21] Enter the qualified home purchase expenses (subject to the lifetime $10,000 limit) in Part III, line 20 of Form 8606 and follow the remaining instructions. Include the completed Form 8606 with your Form 1040.

## Takeaways

Know this: There is no federal income tax hit on a qualified Roth withdrawal. You just have to make sure your withdrawal is actually qualified before pulling the trigger.

The tax rules for non-qualified Roth IRA withdrawals are complicated. That said, everything falls in place when you properly complete Part III of IRS Form 8606 and enter the proper amount (which might be zero) on line 4b of your Form 1040.

The other complicating factor for non-qualified withdrawals is the 10 percent early withdrawal penalty tax, which you must calculate on IRS Form 5329 when it applies.

If you plan to take one or more big non-qualified Roth IRA withdrawals during the year, you need to speak with your tax pro and have him or her advise you on both the front and back ends of your withdrawal.

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[1] IRC Section 408A(d)(2).

[2] IRC Section 408A(d)(2)(B).

[3] Form 1099-R (2021).

[4] Form 1040, U.S. Individual Income Tax Return (2020).

[5] IRC Section 72(t).

[6] IRC Section 408A(d)(4); Reg. Sections 1.408A-6, Q&A-8; 1.408A-6, Q&A-9.

[7] IRS Form 8606, Nondeductible IRAs (2020).

[8] Form 1040, U.S. Individual Income Tax Return (2020).

[9] IRC Sections 408A(d)(3)(F); 72(t).

[10] Reg. Section 1.408A-6, Q&A-8.

[11] IRS Form 8606, Nondeductible IRAs (2020).

[12] IRS Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts (2020).

[13] IRS Form 8606, Nondeductible IRAs (2020).

[14] Ibid.

[15] IRC Sections 408A(d)(2); 72(t); Reg. Section 1.408A-6, Q&A-5.

[16] IRS Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts (2020).

[17] Form 1099-R (2021).

[18] IRC Sections 408A(d)(5); 72(t)(2)(F); 72(t)(8).

[19] IRC Sections 408A(d)(5); 72(t)(2)(F); 72(t)(8).

[20] IRC Sections 408A(d)(5); 72(t)(2)(F); 72(t)(8).

[21] Form 1040, U.S. Individual Income Tax Return (2020).

# Retirement Plans – 2022 – 1 of 2

## Options When You Are Self-Employed and Have No Employees

| Retirement Plan | Maximum Employee Contribution | Maximum Employer Contribution |
|---|---|---|
| **SEP-IRA** | N/A | Up to 20% of your net self-employment income[1] but not to exceed $61,000.[2] |
| **401(k)** | $20,500 ($27,000 if 50 or older)[3] | 20% of your net self-employment income,[4] but not more than $61,000 considering both your employee and employer contributions ($67,500 if 50 or older)[5] |
| **SIMPLE-IRA** | $14,000 ($17,000 if 50 or older) | Plus either:<br>1. A matching contribution equal to the lesser of 3 percent of your defined self-employment income or the amount of your elective deferral;[6] or<br>2. A nonelective contribution of 2 percent of your defined self-employment income limited to no more than $305,000.[7] |
| **Traditional IRA** | $6,000 ($7,000 if 50 or older)[8] | N/A |
| **Roth IRA** | $6,000 ($7,000 if 50 or older)[9] | N/A |
| **Defined Benefit Plan** | | Actuarially determined amount needed to fund annual retirement benefit of up to $245,000[10] |

[1] IRC Sections 401(c)(2); 402(h)(2); 404(h); 408(k)(7)(B); 414(s); 415(c)(1)(A); 415(c)(3)(B).
[2] Notice 2021-61.
[3] IRC Section 401(g); IR 2021-216.
[4] IRC Section 402(i).
[5] Notice 2021-61.
[6] IRC Sections 408(p)(2)(A)(iii); 408(p)(2)(C)(ii)(I).
[7] IRC Sections 408(p)(2)(B); 401(a)(17); Notice 2021-61.
[8] IR 2021-216.
[9] Ibid.
[10] IRC Sections 404(a)(1); 404(a)(8); 415(b); IRC Section 415(b)(1)(A); Notice 2021-61.

**Sole Proprietorship & Partnership**

# Retirement Plans – 2022 – 2 of 2

## Options When You Are the Only Employee

| Retirement Plan | Maximum Employee Contribution | Maximum Employer Contribution |
|---|---|---|
| **SEP-IRA** | N/A | 25% of your wages,[11] but not more than $61,000[12] |
| **401(k)** | $20,500 ($27,000 if 50 or older)[13] | 25% of your wages,[14] but not more than $61,000 considering both your employee and corporate (employer) contributions ($67,500 if 50 or older)[15] |
| **SIMPLE-IRA** | $14,000 ($17,000 if 50 or older) | Plus either:<br>1. A matching contribution of 3 percent[16] of your employee deferral up to 3 percent; or<br>2. A nonelective contribution of 2 percent of compensation[17] to all eligible employees (you)[18] whether or not you make a salary deferral. |
| **Traditional IRA** | $6,000 ($7,000 if 50 or older)[19] | N/A |
| **Roth IRA** | $6,000 ($7,000 if 50 or older)[20] | N/A |
| **Defined Benefit Plan** | | Actuarially determined amount needed to fund annual retirement benefit of up to $245,000[21] |

[11] IRC Section 404(h)(1)(C).
[12] Notice 2021-61.
[13] IRC Section 401(g); IR 2021-216.
[14] IRC Section 402(i).
[15] Notice 2021-61.
[16] IRC Sections 408(p)(2)(A)(iii); 408(p)(2)(C)(ii)(I)
[17] IRC Section 408(p)(2)(B)
[18] IRC Section 408(p)(4)
[19] IR 2021-216.
[20] Ibid.
[21] IRC Sections 404(a)(1); 404(a)(8); 415(b); IRC Section 415(b)(1)(A); Notice 2021-61.

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