Individual Retirement Arrangements (IRAs)

Learning Objectives

- Explain the difference between a traditional individual retirement arrangement (traditional IRA) and a Roth individual retirement arrangement (Roth IRA).
- Explain the requirements that apply to both traditional and Roth IRAs, such as those regarding taxable compensation, maximum annual contributions, spousal IRAs, excess contributions, and the 10% penalty tax for premature distributions.
- Explain important differences between traditional IRAs and Roth IRAs relating to such factors as the deductibility of contributions, eligibility rules that apply to Roth IRAs, the tax treatment of distributions, and minimum distribution requirements.
- Identify the advantages and disadvantages of traditional and Roth IRAs, and list factors that influence an individual's decision of which one to use.
- Describe a Roth conversion and identify situations in which a conversion would be appropriate.

Introduction to IRAs

Learning Objectives: Explain the difference between a traditional individual retirement arrangement (traditional IRA) and a Roth individual retirement arrangement (Roth IRA).
Explain the requirements that apply to both traditional and Roth IRAs, such as those regarding taxable compensation, maximum annual contributions, spousal IRAs, excess contributions, and the 10% penalty tax for premature distributions.

Que. As of the end of 2021, U.S. retirement assets totaled $39.4 trillion. Do you know how much of these assets were in individual retirement arrangements (IRAs)?
Ans: At $13.9 trillion, IRA assets were the largest component of U.S. retirement assets as of the end of 2021. Their dominance has been consistent over time, as well.

An **individual retirement arrangement** can take the form of either an **individual retirement account** or an **individual retirement annuity**. Although many individuals use IRA accounts or IRA annuities to save for retirement during their working years, most IRA assets come from rollovers from employer-sponsored retirement plans.
On a yearly basis, DC plan participants roll over more than $500 billion into IRAs after they retire or change jobs. By 2025, this figure is expected to exceed $760 billion.
The vast majority of these rollovers are from pre-tax accounts in employer-sponsored retirement plans to traditional IRAs.

Individual retirement arrangement: In the United States, a retirement savings vehicle that meets requirements specified in federal tax laws and, thus, receives favorable federal income tax treatment; can take the form of either an individual retirement account or an individual retirement annuity.

Individual retirement account: An individual retirement arrangement that takes the form of a trust or custodial account set up for the exclusive benefit of a taxpayer or a taxpayer's beneficiaries.

Individual retirement annuity: An individual retirement arrangement that takes the form of an annuity issued by an insurance company.

Taxable compensation: In general, money received from work, such as wages and salaries, tips, commissions, and self-employment income.

Types of IRAs

IRAs can be categorized as either traditional IRAs or Roth IRAs, depending on their tax treatment:

- A **traditional IRA** is a type of individual retirement arrangement into which a qualified person can make annual contributions, which may be tax deductible. Investment earnings are tax deferred until funds are withdrawn.
- A **Roth IRA** is a type of individual retirement arrangement that permits people within certain income limits to make nondeductible contributions and to withdraw money on a tax-free basis, provided certain requirements are met.

Later in this lesson, we look at the differences between traditional and Roth IRAs. First, though, we cover what they have in common. On this page, the term IRA refers to either a traditional IRA or a Roth IRA.

Traditional and Roth IRAs have requirements or limitations in the following areas:

- Taxable compensation
- Maximum annual contributions
- Spousal IRAs
- Excess contributions

Traditional individual retirement arrangement: A type of IRA into which a qualified person can make contributions, which may be tax deductible up to specified limits. The owner does not pay taxes on deductible contributions, including any investment earnings on the contributions, until withdrawn.

Roth IRA: A type of individual retirement arrangement that permits people within certain income limits to make nondeductible contributions and to withdraw money on a tax-free basis, provided certain requirements are met.

Que. To be eligible to establish and contribute to an IRA, an individual generally must have received *taxable compensation* during the year. Which of the following items do you think are examples of taxable compensation?

Ans: In general, taxable compensation refers to money received from work, such as wages and salaries, tips, commissions, and self-employment income. Taxable compensation does not include interest and dividend income, pension or annuity income, or earnings and profits from property.

Taxable Compensation Requirement

By limiting contributions to IRAs to people who have taxable compensation, the IRS is attempting to prevent people with investment income only from receiving the tax advantages of an IRA.

Maximum Annual Contribution Limits

An individual can have more than one IRA, and the IRS sets limits on the maximum annual contribution an owner can make to all the owner's IRAs.* These maximum annual contribution limits are adjusted annually for inflation.

Exceptions: When we say "all the owner's IRAs," we are not including IRAs in employer-sponsored retirement plans, such as SEPs and SIMPLE IRA plans. This lesson is on IRAs used by individuals outside of an employer-sponsored retirement plan.

For 2023, the maximum annual contribution that an IRA owner *under age 50* can make is generally the *lesser* of

- $6,500
- The owner's taxable compensation for the year

Example: In 2023, Julia Brody, age 42, had taxable compensation of $64,000. Julia owns an IRA.
Analysis: For 2023, Julia can contribute a maximum of $6,500 to her IRA.

For 2023, the maximum annual contribution that an IRA owner age 50 or older can make is generally the *lesser* of

- $7,500
- The owner's taxable compensation for the year

The additional $1,000 that IRA owners age 50 or older can make is known as a *catch-up contribution*.

Example: Samantha Daniels, age 56, had taxable compensation of $72,000 in 2023.
Analysis: Samantha can contribute a maximum of $7,500 to an IRA for 2023.

Spousal IRAs

One exception to the previous rules applies to a married couple filing a joint tax return, when one member of the couple has little or no taxable compensation during the year. In this case, a contribution can be made to an IRA for that spouse. Although sometimes called a spousal IRA, this IRA is basically the same as a regular IRA, and it can take the form of either a traditional or a Roth IRA.
To be eligible, the couple must have total taxable compensation at least equal to the annual contributions to the IRAs of both individuals.
Example: Graham and Betty Reinhart are married and are both 45 years old. For 2023, Graham had taxable compensation of $56,000, but Betty had no taxable compensation. Graham and Betty file a joint tax return. Graham owns two IRAs, and Betty owns one IRA.
Analysis: For 2023, Graham can contribute a maximum of $6,500 across his two IRAs. A contribution of $6,500 can also be made to Betty's spousal IRA.

Excess Contributions

If an IRA owner makes a contribution that is not permissible, whatever the reason, the owner will have made an **excess contribution(**For a traditional or a Roth IRA, a contribution that is not permissible, whatever the reason.**)**. In general, if the owner does not withdraw the excess contribution by the due date of last year's tax return, plus extensions, the owner will be subject to a 6 percent penalty tax on the amount of the excess contribution for each year it remains in the account. The owner must also withdraw any interest earned on the excess contribution.
Example: In 2023, Fred Thurmond, age 55, contributed $3,500 to one of his IRAs and $4,500 to a second IRA. This combined $8,000 contribution is in excess of the $7,500 limit, resulting in an excess contribution of $500.
Analysis: Fred can avoid the tax penalty by withdrawing $500, plus any interest it has earned, by the due date of last year's tax return, plus extensions. Fred can withdraw the required amount from either or both IRAs. If he does not withdraw this amount in time, he will have to pay a 6% penalty on the $500, or $500 × 0.06 = $30.

Penalty Tax for Premature Distributions

Because IRAs are tax-qualified vehicles, taxable distributions from them are subject to a 10% penalty tax for premature distributions, which are distributions taken before the individual has reached age 59½. The penalty tax applies only to the amount of any withdrawal that is taxable.
Example: Lisa Evert took a $18,000 premature distribution from her IRA. Of this amount, $5,000 was taxable as income. The penalty tax for this distribution will be 10% of $5,000, or $500.

Some exceptions apply to the penalty tax. For example, an IRA owner who takes a distribution from an IRA prior to age 59½ may qualify for the Section 72(t) exception and avoid the penalty tax if the owner meets certain criteria.

Section 72(t) penalty tax exception applies if IRA owner meets any of these criteria:

- Inherited the IRA
- Is totally and permanently disabled

- Is diagnosed with a terminal illness
- Uses the distribution to pay unreimbursed medical expenses that are more than a specified percentage of the owner's AGI
- Takes the distribution as part of a series of substantially equal periodic payments (SEPPs) made at least annually and based on the owner's life expectancy or the joint life expectancy of the owner and the owner's beneficiary
- Is a qualified first-time home buyer who uses the distribution to buy, build, or rebuild a first home, where the total distribution is not more than $10,000
- Uses the distribution to pay qualified higher education expenses, if the total distribution is not more than these expenses
- Uses the distribution to pay the premiums for medical expense insurance due to a period of unemployment, and the total distribution is not more than these premiums
- Has expenses for the birth or adoption of a child (limited to $5,000)
- Lives in a federally declared disaster area

Que. Amanda Landon, single and age 45, owns both a traditional IRA and a Roth IRA. Amanda earns a salary as an IT specialist for the Galleon Company and is also self-employed as a freelance computer programmer. Last year, she accidentally made an excess contribution to her traditional IRA. She also withdrew $5,000 from her Roth IRA to cover expenses related to adopting a child.
Assume that the maximum annual contribution for the current year is $6,500 for an IRA owner under age 50. Which of the following maximum contributions would NOT be permissible for Amanda across her two IRAs?
Ans: The IRS sets limits on the maximum annual contribution an owner can make to ALL the owner's IRAs. So, because Amanda is under age 50, she cannot contribute more than $6,500 to both of her IRAs.

Note: In general, taxable compensation refers to money received from work, such as wages and salaries, tips, commissions, and self-employment income. Taxable compensation does not include interest and dividend income, pension or annuity income, or earnings and profits from property.

Que. If Amanda does not withdraw the excess contribution to her traditional IRA by the due date of last year's tax return, including extensions, she will be subject to a (**6** / **10**) percent penalty tax on the amount of the excess contribution. Amanda (**is** / **is not**) required to withdraw any interest earned on the excess contribution.
Ans: If an IRA owner makes a contribution that is not permissible, whatever the reason, the owner will have made an excess contribution. In general, if the owner does not withdraw the excess contribution by the due date of last year's tax return, including extensions, the owner will be subject to a 6 percent penalty tax on the amount of the excess contribution. The owner must also withdraw any interest earned on the excess contribution.

Note: Although Amanda's $5,000 withdrawal from her Roth IRA is a premature distribution—because she has not attained age 59½—this withdrawal is not subject to the 10% penalty tax because it qualifies for one of the exceptions.

Differences Between Traditional and Roth IRAs

Learning Objective: Explain important differences between traditional IRAs and Roth IRAs relating to such factors as the deductibility of contributions, eligibility rules that apply to Roth IRAs, the tax treatment of distributions, and minimum distribution requirements.

Note: Roth IRA contributions are never deductible, so participation in an employer-sponsored retirement plan doesn't affect the deductibility of contributions to Roth IRAs. For a traditional IRA, if the owner or owner's spouse participated in an employer-sponsored retirement plan during the year, the amount of the deductible contribution for that year may be reduced or eliminated.

Deductibility of Contributions for Traditional IRAs

One of the most popular features of the traditional IRA is the owner's ability to deduct the contributions from taxable income up to the specified maximum annual limits. The deductibility of contributions may be further limited if the owner or the owner's spouse participated in an employer-sponsored retirement plan during the year.

Recall from Module 1 that employer-sponsored retirement plans include defined benefit (DB) plans and defined contribution (DC) plans, such as 401(k) plans, profit sharing plans, 403(b) plans, SEPs, and SIMPLE IRA plans.

Here are the rules:

- If neither the owner nor the owner's spouse participated in an employer-sponsored retirement plan for the year, the owner can deduct from taxable income the amount of the traditional IRA contribution *up to the maximum allowable amount*.
- If either the IRA owner or the owner's spouse participated in an employer-sponsored retirement plan for the year, the amount of the deductible contribution *may be reduced or even eliminated*.

If either the IRA owner or the owner's spouse participated in a retirement plan at work, the deductibility of the contributions depends on two factors: (1) modified adjusted gross income (MAGI) and (2) the tax filing status of the owner or couple, if filing jointly.

What's MAGI?

Modified adjusted gross income (MAGI) is basically a household's gross income adjusted to reflect certain additions and deletions. Let's see how this works:

- **Gross income** includes the amount of money earned in a year *before* any tax deductions. In addition to earned income, gross income includes investment income, any Social Security retirement benefits, unemployment payments, and possibly alimony or child support.
- **Adjusted gross income (AGI)** is gross income *minus* certain adjustments. Common adjustments include pre-tax contributions to retirement plans or health savings accounts (HSAs) and student loan interest paid. AGI will never be more than gross income.

AGI = Gross income – Adjustments

MAGI is found by adding back in certain amounts that were deducted from AGI. Common adjustments include adding back in the deduction taken for IRA contributions and taxable Social Security retirement benefits. For many people, MAGI is close or equal to AGI.

Next, you need to know your tax filing status. Types of tax filing statuses are single, married filing jointly, married filing separately, head of household, and qualifying widow(er) with dependent child.

Once you have this information, you can consult the IRS website to determine the availability of tax deductions for your situation.

2023 IRS Tables for Determining the Deductibility of Traditional IRA Contributions

If you participated in an employer-sponsored retirement plan, use this table to determine whether your MAGI affects the amount of your deduction.

If Your Filing Status Is...	And Your MAGI Is...	Then You Can Take...
Single or head of household	$73,000 or less	A full deduction up to the maximum annual contribution limit
	More than $73,000 but less than $83,000	A partial deduction
	$83,000 or more	No deduction
Married filing jointly or qualifying widow(er)	$116,000 or less	A full deduction up to the maximum annual contribution limit
	More than $116,000 but less than $136,000	A partial deduction
	$136,000 or more	No deduction
Married filing separately	Less than $10,000	A partial deduction
	$10,000 or more	No deduction

If you did not participate in an employer-sponsored retirement plan but your spouse did, use this table to determine whether your MAGI affects the amount of your deduction.

If Your Filing Status Is...	And Your MAGI Is...	Then You Can Take...
Married filing jointly	$218,000 or less	A full deduction up to the maximum annual contribution limit
	More than $218,000 but less than $228,000	A partial deduction
	$228,000 or more	No deduction
Married filing separately	Less than $10,000	A partial deduction
	$10,000 or more	No deduction

Example: Gloria Giamatti is 54 years old and single. She participates in a 401(k) plan at work and owns a traditional IRA. For 2023, Gloria's MAGI was $62,000.
Analysis: Because Gloria's MAGI is less than $73,000, she can deduct all of her IRA contribution for the year, provided she does not contribute more than the maximum allowable amount of $7,500 ($6,500 annual limit plus $1,000 catch-up contribution).

Example: Minnie and Kyle Ozick are married, and both are age 48. Both of them work, although only Minnie participates in an employer-sponsored retirement plan. They file a joint tax return, and each owns a traditional IRA. For 2023, their MAGI is $150,000.

Analysis: Because the couple's MAGI is less than $218,000, Kyle can deduct his IRA contribution for the year, up to the maximum allowable amount of $6,500. However, Minnie cannot deduct her IRA contribution for the year, because the couple's MAGI is more than $136,000.
Note that Kyle uses the second table because he did not participate in an employer-sponsored retirement plan, but his spouse did. Minnie uses the first table because she did participate in an employer-sponsored retirement plan.

MAGI Limits for Roth IRAs

Contributions to Roth IRAs are never tax deductible—so the previous rules on deductibility and participation in an employer-sponsored retirement plan are irrelevant to a Roth IRA owner.
But…a person or couple earning above a set threshold may not be able to contribute to a Roth IRA, or they may face limits on how much can be contributed.

Again, MAGI is what's important.

The following table summarizes the 2023 MAGI limits for Roth IRA owners based on filing status.

MAGI Limits for Roth IRAs by Filing Status

If You Have Taxable Compensation and Your Filing Status Is...	And Your MAGI Is...	Then You Can Make...
Single or head of household	Less than $138,000	The total allowable contribution
	At least $138,000 but less than $153,000	A partial contribution
	$153,000 or more	No contribution
Married filing jointly or qualifying widow(er)	Less than $218,000	The total allowable contribution
	At least $218,000 but less than $228,000	A partial contribution
	$228,000 or more	No contribution
Married filing separately	Less than $10,000	A partial contribution
	$10,000 or more	No contribution

Example: Jody Rosenbaum, a single woman age 58, owns a Roth IRA. Jody had MAGI of $120,000 for 2023.
Analysis: For 2023, Jody can contribute a total of $7,500 to her Roth IRA. Note that, if Jody's MAGI had been over $138,000, she would have been allowed to make only a partial contribution to her Roth IRA. If her MAGI had been more than $153,000, no Roth IRA contribution would have been allowed.

Que. In the United States, income earned through employment is taxed as **ordinary income (**For U.S. federal tax purposes, income that is not a capital gain, including money received as wages, salaries, taxable interest, taxable pensions, and unemployment compensation.). The federal income tax rate on ordinary income approaches 40% for high-income earners.
Income earned by selling an investment is known as a **capital gain (**The amount by which the selling price of an asset exceeds its purchase price.**)**. Long-term capital gains apply to sales of investments owned for more than one year. Tax rates on long-term capital gains range from 0%-20%, which is usually lower than ordinary income tax rates.
Do you think distributions from IRAs are taxed at the lower income tax rates?
Ans: Distributions from traditional IRAs—but not from Roth IRAs—are taxed as ordinary income.

When it comes to the taxation of distributions, an important rule of thumb is as follows:

How the money goes in the IRA—meaning, was it taxed?—affects how it comes out.

This rule applies whether we're talking about contributions to an IRA or earnings on contributions.

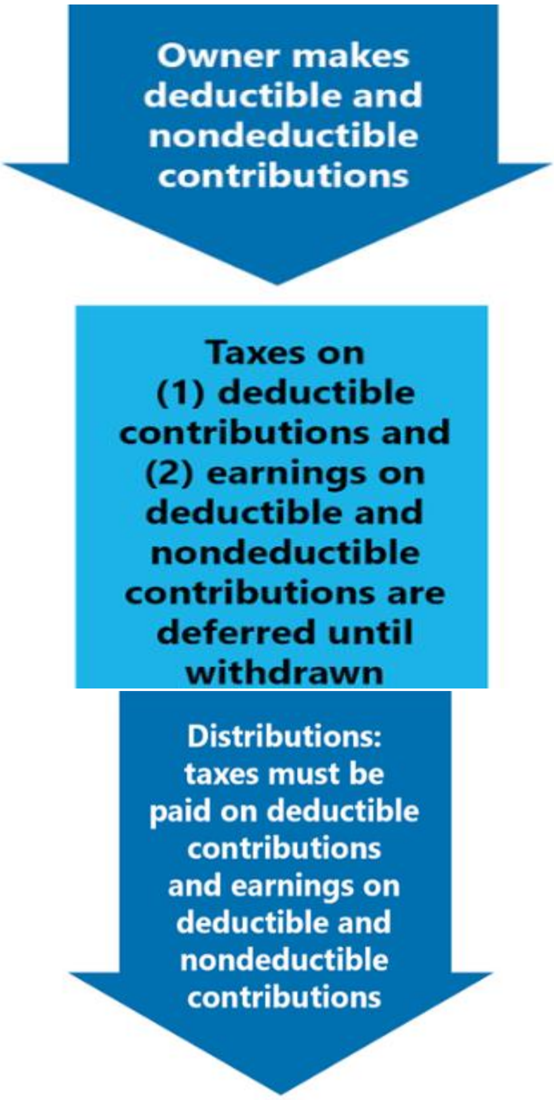
Distributions from Traditional IRAs

Traditional IRA owners can take distributions from their accounts at any time, although remember: a 10% penalty tax may apply if the owner takes premature distributions.

Distributions from a traditional IRA may be fully or partially taxable as ordinary income for the year in which they are received.

If the owner made only deductible contributions, the owner will pay income tax on the full amount of any distribution because the contributions and earnings have never been taxed.

If the owner made **any nondeductible contributions**, the owner will not pay income taxes on any part of a distribution that is a return of nondeductible contributions. That's because the owner has already paid taxes on these contributions. The owner will, however, pay income tax on any earnings attributed to these nondeductible contributions.



Are you wondering—why would a traditional IRA owner make nondeductible contributions?
Recall that not all IRA owners are eligible to make a fully deductible contribution up to the maximum allowable limit. In that case, the owner could decide to also contribute on a nondeductible basis.

Example: This year, Jerome Stern, age 40 and the owner of a traditional IRA, was eligible to deduct only $2,000 of his total contribution of $6,000. The remaining $4,000 was a nondeductible contribution.

A traditional IRA owner who is not eligible to contribute to a Roth IRA could make a nondeductible contribution to the traditional IRA. The owner would pay taxes on the nondeductible contribution now—but might be able to convert these funds to a Roth IRA later. The amount converted to the Roth IRA would grow tax deferred and could be withdrawn tax free in the future, provided certain conditions are met. We discuss conversions later in the lesson.

Example: Suzanne Strong, age 45 and single, does not own any IRAs. She would like to contribute to a Roth IRA, but she is not eligible because her income is above the IRS threshold. Instead, Suzanne opens a traditional IRA and makes a nondeductible contribution to it. The following month, she converts the balance in the traditional IRA to a Roth IRA.
Because Suzanne doesn't own any other IRAs, only the amount of the conversion above the contribution amount (if there were earnings in the time between the original contribution and the conversion to the Roth IRA) would be taxable.

Distributions from Roth IRAs

One of the key features of a Roth IRA is that the owner has the ability to withdraw money, including earnings, from the account on a tax-free basis. To do this, however, the distribution must be considered a **qualified distribution** (For a Roth IRA, a distribution that is tax free because it satisfies certain requirements).

These requirements have two parts:

1. The owner may not take the distribution any sooner than five years after the beginning of the year for which the owner first set up and contributed to a Roth IRA.
2. *One* of the following conditions must apply:
   - The owner has reached age 59½.
   - The owner is disabled.
   - The distribution is made to the beneficiary of the Roth IRA owner after the owner's death.
   - The owner withdraws funds of no more than $10,000 to buy, build, or rebuild a first home.

Example: In 2014, Marita Lopez, age 53, opened her first Roth IRA with a contribution of $3,000. In 2019, Marita opened a second Roth IRA with a contribution of $2,000. Two years later, in 2021, she withdrew $5,000 from the second Roth IRA.

Analysis: Marita will pay no taxes on her withdrawal of $5,000 because she has satisfied both the five-year requirement and one of the other requirements for a qualified distribution (she is now age 60, so she has reached age 59½). Although Marita opened her second Roth IRA only two years before her withdrawal, the five-year period began on January 1, 2014, the beginning of the first year for which she contributed to a Roth IRA.

If both parts of the requirement are not met, then the distribution is a nonqualified distribution, and the owner generally will be subject to income tax on any amount of the distribution that represents earnings. If the Roth IRA owner is under age 59½, the 10% penalty tax will also apply to any amount of such a distribution that represents earnings.

The figure below illustrates the process of determining whether a distribution from a Roth IRA is a qualified distribution.

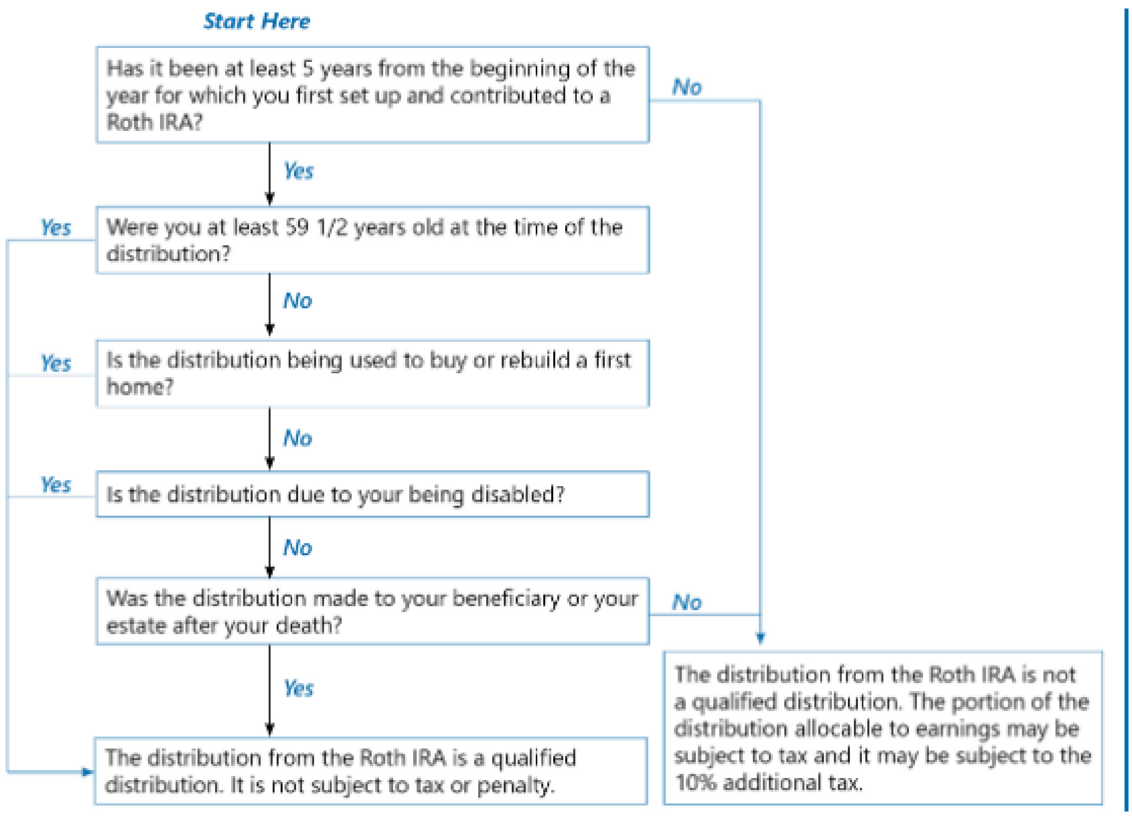


Image description: Is the Distribution from Your Roth IRA a Qualified Distribution? (flow chart) Has it been at least 5 years from the beginning of the year for which you first set up and contributed to a Roth IRA? If the answer is No, your distribution is not a qualified distribution. The portion of the distribution that represents earnings may be subject to tax and a 10% additional tax. If the answer is Yes, proceed to the next question. Were you at least 59½ years old at the time of the distribution? If the answer is No, go to the next question. If the answer is Yes, the distribution is a qualified distribution, which means it is not subject to tax or a penalty. Is the distribution being used to buy or rebuild a first home? If the answer is No, go to the next question. If the answer is Yes, the distribution is a qualified distribution, which means it is not subject to tax or a penalty. Is the distribution due to your being disabled? If the answer is No, go to the next question. If the answer is Yes, the distribution is a qualified distribution, which means it is not subject to tax or a penalty. Was the distribution made to your beneficiary or your estate after your death? If the answer is No, your distribution is not a qualified distribution. The portion of the distribution that represents earnings may be subject to tax and a 10% additional tax. If the answer is Yes, the distribution is a qualified distribution, which means it is not subject to tax or a penalty.

Even if a distribution from a Roth IRA is *not* a qualified distribution, the owner may not have to pay income taxes on it if it comes from contributions. The process of determining the taxability of nonqualified distributions from a Roth IRA is complicated and beyond the scope of this lesson.

RMD Rules

Another difference between traditional IRAs and Roth IRAs concerns **required minimum distributions (RMDs)**. (For certain retirement plans and IRAs, the amount that must be distributed each year from the plan or IRA.) Traditional IRAs are subject to the RMD rules, whereas Roth IRAs are not. Click or touch each IRA type below.

Traditional IRAs

As of 2023, traditional IRA owners generally must begin taking RMDs by April 1 of the year following the year in which the owner attains age 73. For each year after the first distribution year, the owner must take the distribution by December 31 of that year. Failure to take an RMD generally results in a penalty tax of 25%, which is assessed on the amount of the RMD that was not taken.

Roth IRAs

Roth IRA owners are not required to take RMDs during the owner's lifetime. Therefore, a Roth IRA owner never has to withdraw any money from the account if the owner so chooses. This aspect of the Roth IRA makes it an attractive option for someone who wishes to leave a tax-free legacy to heirs. If an owner of a Roth IRA also owns a traditional IRA, the owner may not take RMDs for the traditional IRA from the Roth IRA.

Note that if a retirement plan contains a designated Roth feature, a plan participant's Roth account is subject to the RMD rules during the lifetime of the participant. Some people choose to roll the funds from the Roth account over to a Roth IRA, which allows them to decide the timing and amount of any distributions.
The process of calculating RMDs is beyond the scope of this lesson. Also beyond the scope of this lesson is what happens to RMDs after the death of the owner of a traditional IRA or Roth IRA.

2023 IRS Tables for Determining the Deductibility of Traditional IRA Contributions

If you participated in an employer-sponsored retirement plan, use this table to determine whether your MAGI affects the amount of your deduction.

If Your Filing Status Is...	And Your MAGI Is...	Then You Can Take...
Single or head of household	$73,000 or less	A full deduction up to the maximum annual contribution limit
	More than $73,000 but less than $83,000	A partial deduction
	$83,000 or more	No deduction
Married filing jointly or qualifying widow(er)	$116,000 or less	A full deduction up to the maximum annual contribution limit
	More than $116,000 but less than $136,000	A partial deduction
	$136,000 or more	No deduction
Married filing separately	Less than $10,000	A partial deduction
	$10,000 or more	No deduction

If you did not participate in an employer-sponsored retirement plan but your spouse did, use this table to determine whether your MAGI affects the amount of your deduction.

If Your Filing Status Is...	And Your MAGI Is...	Then You Can Take...
Married filing jointly	$218,000 or less	A full deduction up to the maximum annual contribution limit
	More than $218,000 but less than $228,000	A partial deduction
	$228,000 or more	No deduction
Married filing separately	Less than $10,000	A partial deduction
	$10,000 or more	No deduction

Que. Which of the following owners of traditional IRAs would be allowed to take a full deduction, up to the maximum annual contribution limit, for 2023?
Ans: If neither the owner nor the owner's spouse participated in an employer-sponsored retirement plan for a given year, the owner can deduct from taxable income the amount of the traditional IRA contribution up to the maximum allowable amount.

- [ ] Daniel Shu is single, participated in an employer-sponsored retirement plan in 2023, and had MAGI of $100,000 for 2023.
- [x] Shu-Ling Lee is single and had MAGI of $200,000 for 2023. She did not participate in an employer-sponsored retirement plan in 2023.
- [ ] Julio Godinez filed a joint tax return with his spouse, Marisol, and they had MAGI of $400,000 for 2023. Julio did not participate in an employer-sponsored retirement plan in 2023, but Marisol did.
- [x] Grace Sharp filed a joint tax return with her spouse, Nicolas, and they had MAGI of $300,000 for 2023. Neither participated in an employer-sponsored retirement plan in 2023.

2023 MAGI Limits for Roth IRAs by Filing Status

If You Have Taxable Compensation and Your Filing Status Is...	And Your MAGI Is...	Then You Can Make...
Single or head of household	Less than $138,000	The total allowable contribution
	At least $138,000 but less than $153,000	A partial contribution
	$153,000 or more	No contribution
Married filing jointly or qualifying widow(er)	Less than $218,000	The total allowable contribution
	At least $218,000 but less than $228,000	A partial contribution
	$228,000 or more	No contribution
Married filing separately	Less than $10,000	A partial contribution
	$10,000 or more	No contribution

Que. Jodi Armour, who owns a Roth IRA, filed a joint tax return with her spouse for 2023. The couple had MAGI of $150,000 for 2023, and both of them had taxable compensation for the year. Was Jodi allowed to contribute the maximum allowable amount to her Roth IRA for 2023?
Ans: Jodi had taxable compensation for 2023, and her tax filing status was married filing jointly. Because the couple's MAGI was less than $218,000, Jodi was allowed to contribute the maximum allowable amount to her Roth IRA for 2023. Jodi's spouse would also be eligible to contribute the maximum allowable amount to a Roth IRA for the year.

Note: If the owner made both deductible and nondeductible contributions, the owner will not pay income tax on any part of a distribution that is a return of nondeductible contributions because the owner has already paid taxes on these contributions. The owner will, however, pay income tax on any earnings attributed to deductible and nondeductible contributions.
Que. In 2013, Russell White, age 52, opened his first Roth IRA with a contribution of $4,000. In 2018, Russell opened a second Roth IRA. Three years later, in 2021, he withdrew $5,000 from the second Roth IRA. Will Russell pay any taxes on this withdrawal?
Ans: Russell will not pay taxes on his withdrawal of $5,000 because he has satisfied both the five-year requirement and one of the other requirements for a qualified distribution (he is now age 60, so he has reached age 59½). Although Russell opened his second Roth IRA only three years before his withdrawal, the five-year period began on January 1, 2013, the beginning of the first year for which he contributed to a Roth IRA.

Note: For traditional IRAs, as of 2023, the general rule is that the owner must begin taking RMDs from the account by April 1 of the year following the year in which the owner attains age 73. Therefore, Renee must take an RMD for 2023. Owners of Roth IRAs, like Jackson, never have to take RMDs during their lifetimes.

Pros and Cons of Traditional and Roth IRAs

Learning Objectives: Identify the advantages and disadvantages of traditional and Roth IRAs, and list factors that influence an individual's decision of which one to use.
Describe a Roth conversion and identify situations in which a conversion would be appropriate.

Que. The traditional IRA and the Roth IRA have different eligibility requirements and offer different tax benefits. If an individual who is eligible for both a traditional and Roth IRA is primarily interested in leaving a legacy to heirs, the best option is likely.
Ans: There are several factors an individual considers when choosing between a traditional and a Roth IRA. However, since a Roth IRA isn't subject to RMD requirements during the owner's lifetime and qualified distributions are tax free, a Roth IRA often will be a better choice for someone who wants to leave a legacy to heirs. Let's look at some other factors.

Traditional or Roth IRA?

When choosing between a traditional IRA and a Roth IRA, people are likely to consider

- Tax issues
- Eligibility requirements
- The rules dictating RMDs

These factors are not necessarily fixed in time. For example, someone who opens a traditional IRA could decide later that the Roth IRA is the better choice. In this situation, the owner could (1) open a Roth IRA and contribute to it or (2) convert the traditional IRA to a Roth IRA.

Conversions

All owners of traditional IRAs, regardless of income level, have the ability to convert all or part of the traditional IRA to a Roth IRA. A **conversion** (The process of changing a traditional IRA into a Roth IRA.) can be done in one of three ways:

Types of Conversions

- **Rollover:** The owner receives the amount of the traditional IRA to be converted and then rolls it over to a Roth IRA within 60 days.
- **Trustee-to-Trustee Transfer:** The owner directs the trustee of the traditional IRA to transfer all or part of the IRA's account balance to the trustee of the Roth IRA.
- **Same Trustee Transfer:** The owner asks the trustee to transfer an amount from the traditional IRA to the Roth IRA. If the owner wants the entire account balance converted, the trustee can redesignate the IRA account as a Roth IRA. A same trustee transfer is used when the same institution holds the traditional IRA and the Roth IRA.

In the year of conversion, the individual must pay income taxes on the amount of the traditional IRA that is converted—unless the owner made any nondeductible contributions. In that case, an IRS formula applies across all IRAs the individual owns in order to pro-rate the portion of the conversion that is attributed to deductible contributions and investment earnings subject to taxation.

An IRA owner may decide to exercise a conversion in a year for which the owner expects to have a lower tax bill. By paying the relatively low tax bill now, the owner gains the advantage of having a Roth IRA from which the owner can receive qualified distributions tax free in the future.

Whenever feasible, the IRA owner should pay the taxes on the conversion using money outside of the IRA—that way, the owner will avoid any tax penalties, and the account balance in the IRA will continue to grow on a tax-free basis.

Tax Issues

Tax issues are generally important in choosing between a traditional IRA and a Roth IRA:

Traditional IRA	Roth IRA
For people who expect to be in a **lower** tax bracket at retirement, the **traditional IRA** has certain advantages.	For people who expect to be in a **higher** tax bracket at retirement or who are uncertain what their future tax bracket will be, the **Roth IRA** has certain advantages.
Traditional IRA owners gain an immediate tax advantage because deductible contributions reduce their tax liability during their working years, when their tax rate may be higher. Although these owners must pay taxes on any IRA distributions during retirement, if their tax rate is lower, they may pay less in taxes.	Although these owners pay taxes on their Roth IRA contributions during their working years, at retirement, they do not have to pay taxes on qualified distributions. Future tax rates become a nonissue with this strategy.

Eligibility Requirements

For a traditional IRA, participation in an employer-sponsored retirement plan by either the individual or a spouse—combined with the individual's or couple's MAGI—may affect the deductibility of the individual's contributions to the traditional IRA. Roth IRAs also have an eligibility requirement based on the individual's—or couple's, if filing a joint return—MAGI. However, certain individuals and couples will fall between the upper limits of the traditional IRA rules and those of the Roth IRA rules.

Example: For 2023, Kyra and Nathan Bryson, a married couple, both participated in employer-sponsored retirement plans at work. They filed a joint tax return and had MAGI of $145,000.

Analysis: Due to their participation in the employer-sponsored retirement plans and their MAGI of $145,000, Kyra and Nathan were ineligible for any deductible contributions to a traditional IRA for 2023. Because their MAGI was less than $218,000, however, they could each contribute the maximum allowable amount to a Roth IRA for 2023.

Rules Dictating RMDs

Recall that, as of 2023, owners of traditional IRAs generally must begin taking RMDs from their accounts by April 1 of the year after the year they have attained age **73**. In contrast, Roth IRAs have no RMD requirements during the owner's lifetime. This feature makes the Roth IRA a better choice for individuals who wish to leave their money in the account. The table below compares and contrasts traditional IRAs and Roth IRAs.

	Traditional IRA	Roth IRA
Must the owner* have taxable compensation to establish and contribute to? *Or spouse if filing jointly	Yes	Yes
Is there an annual contribution limit?	Yes	Yes
Can the owner make deductible contributions?	Yes, in certain situations	No
Are investment earnings tax deferred or tax free?	Tax deferred	If the earnings are part of a qualified distribution, they are tax free; if they are part of a nonqualified distribution, they are taxed upon withdrawal
Are contributions taxed at withdrawal?	Yes, unless the owner made nondeductible contributions	No
Are there penalties for early withdrawals?	Yes, unless an exception applies	Yes, unless an exception applies
Are RMDs required during the lifetime of the account owner?	Yes	No

Que. The (**traditional** / **Roth**) IRA permits tax-free distributions, provided certain requirements are met. The (**traditional** / **Roth**) IRA offers the possibility of reducing the owner's tax liability in any year in which a contribution is made.

Ans: Although Roth IRA owners must pay taxes on their contributions, they have the option of taking tax-free distributions from their Roth IRAs later. Traditional IRA owners who make deductible contributions can reduce their tax liability in any year in which they contribute to the IRA.

Que. The following individuals would like to establish and contribute to an IRA:

- Claiborne Rice wants to be able to make both deductible and nondeductible contributions to his IRA.
- Lydia Samford does not want to have to take RMDs from her IRA during her lifetime.

Based solely on this information, a Roth IRA would be appropriate for

Ans: Owners of Roth IRAs never have to take RMDs during their lifetimes, so a Roth IRA would be appropriate for Lydia. Only traditional IRAs allow deductible contributions, so Claiborne would be better off with a traditional IRA.

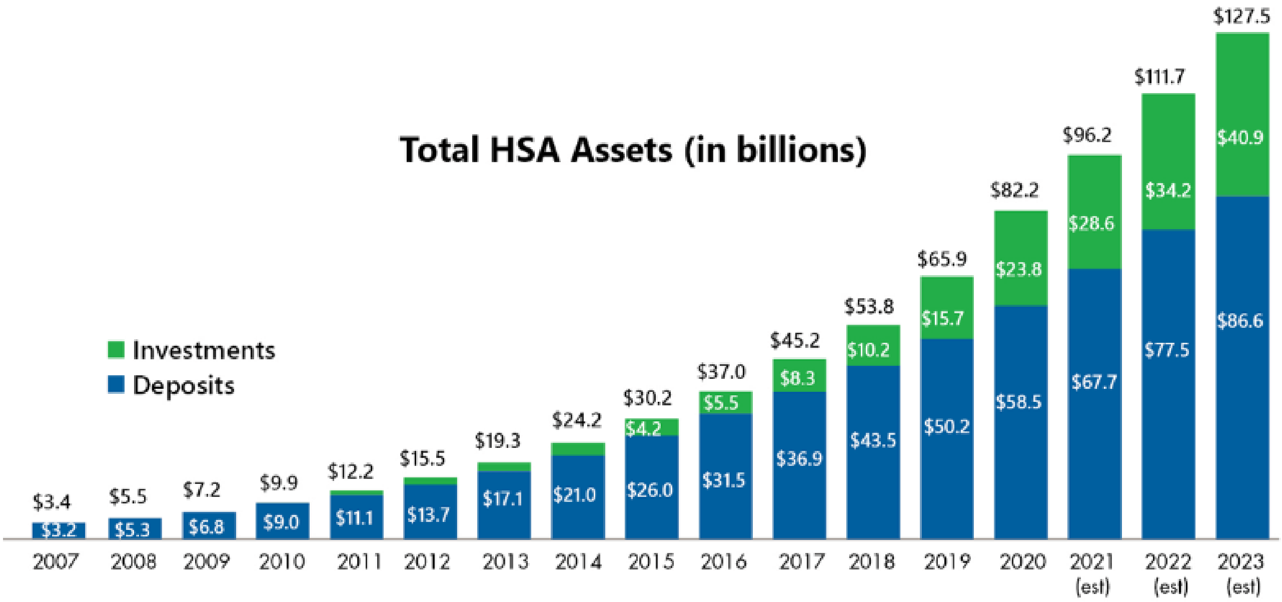
Health Savings Accounts (HSAs)

Learning Objectives: Describe the characteristics of a health savings account (HSA) and explain how individuals can use HSAs to save for retirement.
Explain the tax treatment of HSA distributions

Created in 2003 as a way for people with a high-deductible health insurance plan to pay for medical expenses, **health savings accounts (HSAs)** (A tax-advantaged account in which an individual can accumulate money to pay for qualified medical expenses.) have become a way for people to save money to cover healthcare costs in retirement. In fact, a survey of 401(k) participants who are also enrolled in an HSA found that 54% of respondents intended to use HSA funds in retirement.

Que. At the end of 2020, there were 60 million 401(k) plan accounts worth almost $7 trillion in the United States. In comparison, how many HSAs do you think existed at the end of 2020?
Ans: According to Devenir's 2020 Year-End HSA Research Report, there were just over 30 million HSAs at the end of 2020, holding a total of $82.2 billion in assets.

The graph below shows the growth in HSA assets from 2007 to 2023.



HSAs are emerging as a retirement planning tool, earning them the nickname "Healthcare IRAs." According to a survey by Charles Schwab, 38% of respondents consider an HSA a "must-have" benefit. Almost 80% of the respondents reported having access to an HSA at work, and half of the respondents owned and were contributing to an HSA.

Even though adoption of HSAs is growing, more than 80% of employers cited employee education as a barrier to expanding the use of these accounts. "It's heartening to see employers and employees increasingly recognize the value of HSAs—not only as a way to save for today's health expenses, but also as an integral part of a retirement saving plan," said Tina Wilson, Senior Vice President and Chief Product Officer at Empower Retirement. "We need to continue to find new ways to educate those employees about the tremendous tax advantages of HSAs, while also making it easier for them to enroll."

In this lesson, we'll discuss the characteristics of HSAs and how these accounts can help individuals save for retirement.

Characteristics of HSAs

HSAs are a type of tax-advantaged account that individuals can use to pay for qualified medical expenses. Unlike other accounts used for this purpose, such as flexible spending accounts and health reimbursement arrangements, all of the money in an HSA can remain in the account from year to year.

As with an IRA, HSA funds belong to the account owner and can only be owned by one person (and not jointly with another person). An HSA is portable, meaning an individual still owns the account when changing employers or leaving the workforce. Account owners can name a beneficiary to inherit the funds when they die.

For many people, the biggest advantage of owning an HSA is the "triple-tax" benefit:

3. Contributions are made with ***pre-tax dollars***, not subject to federal and, in most cases, state income taxes.*
4. Earnings on the account balance accumulate ***tax free***.
5. Withdrawals to pay for qualified medical expenses are ***tax free***.

*State taxes may apply in California and New Jersey.

Wow! With so many advantages, why don't more people own an HSA?

An individual may not own an HSA for several reasons, and an HSA does not fit all circumstances. Individuals must have a certain type of health insurance plan to meet HSA eligibility requirements, and this plan often requires the person to pay more for non-preventive medical expenses than the person would if insured under other types of health insurance. For those who are eligible, lack of awareness, an intimidating enrollment process, or prioritization of other spending may prevent them from contributing to an HSA.

Eligibility

In order to be eligible to contribute to an HSA, an individual must be enrolled in a **high-deductible health plan (HDHP) (**A health insurance plan that typically has a higher deductible and lower premiums than a traditional health insurance plan. Usually used in association with a health savings account to provide benefits for qualified medical expenses.**)**. HDHPs may be offered through an employer or purchased as individual policies.

As the name states, an HDHP has a high deductible requirement, which must be met before the plan starts paying medical costs. HDHPs may charge lower premiums than other health insurance plans, but the insured could incur more medical costs in a given year because of the higher deductible. To cap total medical expenses, the IRS sets an annual **out-of-pocket maximum** (In a health insurance plan, a specified maximum amount that limits the insured person's payment obligations. Once the insured reaches the out-of-pocket maximum, the insurance pays all further covered costs.) amount for HDHPs, as shown below.

2023 HDHP Deductible Minimums and Out-of-Pocket Spending Limits

	Individual	Family
Minimum Deductible	$1,500	$3,000
Maximum Out-of-Pocket	$7,500	$15,000

Employers often offer HSAs in conjunction with HDHPs to enable individuals to save for deductibles and out-of-pocket expenses with pre-tax dollars. For example, HSA funds can be used for **copayments** not covered by the insurance plan.
In order to contribute to an HSA, an individual must not be

- Covered by other health insurance, except selected other coverage permitted by the IRS
- Enrolled in Medicare
- Claimed as a dependent on someone else's tax return

Other Coverage Permitted by the IRS

You can have additional insurance that provides benefits only for the following items:

- Liabilities incurred under workers' compensation laws, tort liabilities, or liabilities related to ownership or use of property

- A specific disease or illness
- A fixed amount per day (or other period) of hospitalization

You can also have coverage (whether provided through insurance or otherwise) for the following items:

- Accidents
- Disability
- Dental care
- Vision care
- Long-term care
- Telehealth and other remote care (for plan years beginning before 2022)

Contributions

Contributions to an HSA can be made by individuals, employers, or even others on an individual's behalf.
Similar to IRAs and workplace plans, the IRS sets annual contribution limits for HSAs and allows catch-up contributions for older account owners. However, the age when catch-up contributions may begin is higher for HSAs—age 55, instead of age 50 for IRAs and workplace plans. The following figure shows the contribution limits and catch-up contribution provision for 2023.

2023 Annual HSA Contribution Limits	
Contribution limit (single)	$3,850
Contribution limit (family)	$7,750
Additional catch-up provision (for those age 55+)	$1,000

FICA: Federal Insurance Contributions Act; the law that requires mandatory payroll deductions from workers' paychecks and matching taxes from employers to pay benefits to current Social Security and Medicare recipients. The two separate taxes, one for Social Security and one for Medicare, are treated as one amount that is referred to as "payroll taxes" or FICA.

Employee Tax Deductions

Contributions that come directly from payroll deductions reduce an employee's annual taxable income *and* are not subject to **FICA** taxes. Total FICA taxes are split between an employer and employee (7.65% each: 6.2% Social Security + 1.45% Medicare), so both the employer and employee realize these savings.

Employer Tax Deductions

Contributions made by an employer on behalf of an employee are excluded from the employee's income and are a deductible expense for the employer. In addition, the employer's payroll tax liability is reduced because, like the employee contributions, the employer contributions are not subject to FICA taxes. This favorable tax treatment may encourage employers to offer and contribute to HSAs for their employees.

Self-Employed Tax Deductions

Individuals, such as the self-employed, who contribute outside of payroll can deduct the contributions from current income but cannot reduce the FICA taxes owed.

Example: Jamie Johnson, single and age 35, enrolled in an HDHP with an HSA through her employer. Jamie's contributions to the HSA are made by payroll deductions. Jamie contributed $2,600 for the year, and her employer contributed $1,000. Jamie is in the 24% federal tax bracket and 6% state tax bracket in a state that does not tax HSA contributions.

The table below summarizes Jamie's tax savings from contributing to an HSA.

	Jamie's $2,600 Payroll Contribution
Federal Tax Savings (24%)	$624
State Tax Savings (6%)	$156
FICA Tax Savings (7.65%)	$199
Total Tax Savings on HSA Contribution	**$979**

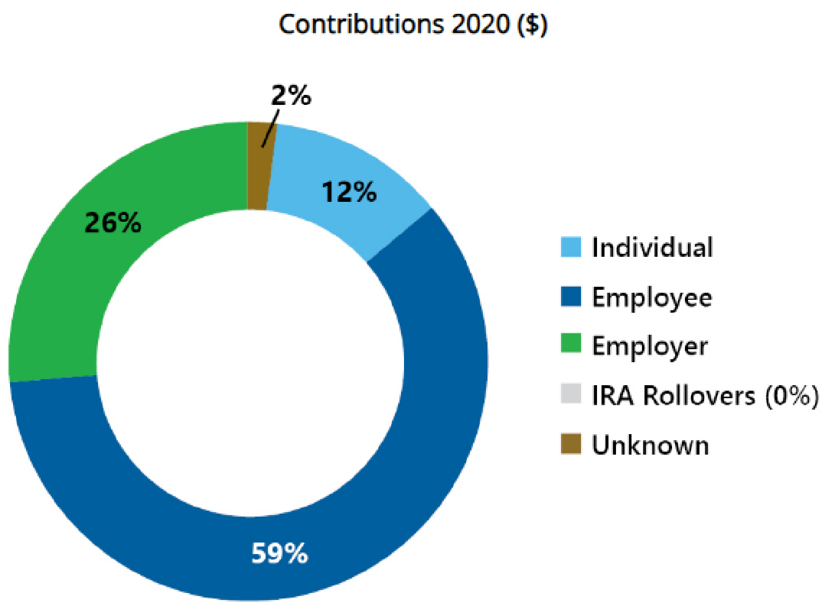
Jamie's employer would save on its portion of FICA taxes for Jamie's contribution of $2,600 plus its own $1,000 contribution (0.0765 x $3,600 = $275). In addition, the employer would be able to take a tax deduction of $1,000 for the employer contribution.

But what if Jamie made contributions directly to her HSA instead of by payroll deduction?

	Jamie's $2,600 Payroll Contribution
Federal Tax Savings (24%)	$624
State Tax Savings (6%)	$156
FICA Tax Savings (7.65%)	$0
Total Tax Savings on HSA Contribution	**$780**

An individual can fund an HSA with a rollover from a traditional or Roth IRA. The rollover amount ***does*** count toward the annual contribution limit, reducing the amount that may be contributed from other sources. Only **one** rollover from a traditional or Roth IRA is allowed during the account owner's lifetime.

See below for a graph showing the sources of contributions to HSAs for 2020.



The average amounts of contributions by source for 2020 were

- $870 by employers
- $2,054 by employees

- $2,033 for individuals with accounts not associated with an employer

Consolidation of HSA Funds

Sometimes a person may own more than one HSA. For example, a change in employment may result in a need for opening an individual HSA or enrolling in a new employer's HSA. Consolidating these accounts can make managing HSA funds easier for the owner in the long run.

Click or touch the boxes below to find out more about how these transfer and rollover methods work.

Trustee-to-Trustee Transfer

Individuals who own more than one HSA can move funds from one account to another through a trustee-to-trustee transfer, which directly sends funds from one financial institution holding an HSA to an HSA at another financial institution. This transfer does not count toward the account owner's annual contribution limit.

Rollover Between HSAs

An HSA owner may conduct a rollover to another HSA, requesting a check from the current financial institution and then depositing it into the other account. An HSA owner must complete the rollover transaction within 60 days of receiving the check and may only make one HSA rollover per one-year period. This type of rollover does not count toward the annual contribution limit.

Excess Contributions

Recall that IRAs have penalties for excess contributions. In a similar manner, if contributions to an HSA exceed the annual contribution limit, the owner will have made an excess contribution. In general, if the owner does not withdraw the excess contribution by the due date of that year's tax return, including extensions, the owner will be subject to a 6% penalty tax on the amount of the excess contribution for each year it remains in the account. The owner must also withdraw any interest earned on the excess contribution.

HSAs allow account owners to invest the money in their HSAs, thereby growing the balance tax free. Typically, the account owner must maintain a minimum cash balance, which earns a minimal interest rate. Any amount above this minimum amount, known as the investment threshold, can be invested.

Que. For 2020, how many HSA owners do you think had invested the cash in their accounts?

Ans: A 2020 survey found that only 6% of HSA owners had invested the cash in their accounts.

Why don't more people invest their HSA funds?

1. Need the money for current medical expenses

Some account owners use their HSAs as a healthcare checking account, making contributions and withdrawing them to pay for qualified medical expenses as they occur. If owners use the account as the primary payment method for current medical expenses, the balance may not reach the threshold required for investment.

2. Did not select investments

Financial institutions that administer HSAs typically require a minimum cash balance, only allowing investments of account balances above the minimum. Over time, contributions may build up the cash balance, but the account owner either isn't aware of the ability to invest the funds or doesn't take the steps to set up investment directives once the threshold is met.

3. Have a low risk tolerance or capacity

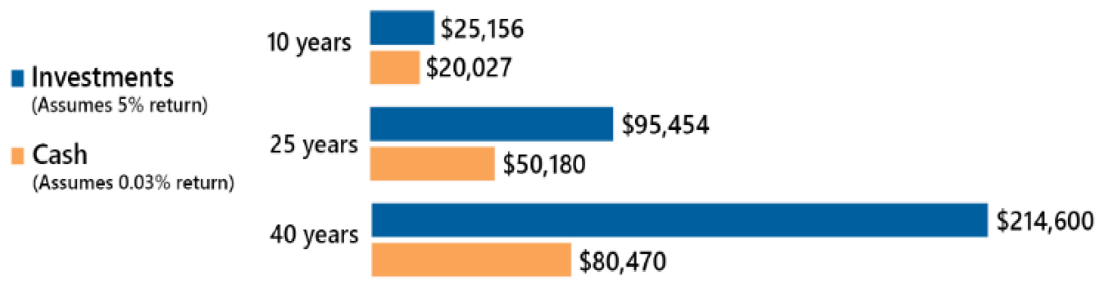
Invested funds could lose value, so risk-averse account owners or those needing a reserve for emergency medical expenses may choose to keep the balance in cash rather than risk losing any of the funds.

4. Are not aware of growth potential

Because of the lower contribution limits in HSAs compared to most workplace retirement plans, some account owners may not think HSA contributions are worth investing, but the investment earnings can add up over time.

According to the Employee Benefit Research Institute (EBRI), HSA owners who have higher balances, or who held the account for a longer period, were more likely to invest the savings. Investment options for HSAs typically include a menu of mutual funds, similar to 401(k) plans. Some account administrators also allow account owners to invest HSA funds directly in stocks, bonds, and CDs.

See the illustration below for the projected growth of $2,000 contributed annually to an HSA. And remember—all that money is growing tax free!



Automated features can make HSA investing easier. For example, an HSA owner may be able to set a cash limit for the account and authorize balances above that amount to transfer automatically into selected investment options. The automation feature ensures the regular investment of fund contributions while leaving a cash balance available for immediate medical expenses.

Example: Returning to the earlier example with Jamie Johnson's HSA, assume the financial institution holding the HSA, Bright Bank, requires a minimum of $500 in cash in the account before allowing investments.

Recall that Jamie, single and age 35, opened the HSA and contributed $2,600 for the year, and her employer contributed $1,000. Once the contributions reached the $500 cash threshold, Jamie could direct that any additional contributions be invested in the available mutual fund options Bright Bank offers for the account.

If Jamie made no withdrawals from the account for medical expenses during the year, she could invest a maximum of $3,100 ($2,600 contribution + $1,000 employer contribution - $500 cash threshold). If Jamie continues in future years to invest contributions rather than using the funds for current medical expenses, her HSA could grow significantly over a thirty-year period, providing a tax-free nest egg to pay for medical expenses in retirement.

- An individual must be enrolled in a high-deductible health plan (HDHP) and not enrolled in Medicare to be eligible to open and contribute to an HSA.
- One of the "triple-tax" benefits of an HSA is that earnings grow tax free.
- HSAs are portable, funds in the account can remain in the account from year to year, an account owner can name a beneficiary for the account, and HSAs are funded with pre-tax dollars. However, only an individual may own an HSA; an HSA cannot be owned jointly with another person.
- When funding an HSA, annual contribution limits apply to: The amount of individual and employer contributions and any rollover from a traditional or Roth IRA count toward the annual contribution limit for an HSA. Note that only one rollover from a traditional or Roth IRA is allowed during a lifetime. Trustee-to-trustee transfers and rollovers between HSA accounts are not counted in the annual contribution limit because they do not involve "new money" coming into the HSA.

Distributions from HSAs

Learning Objective: Explain the tax treatment of HSA distributions.

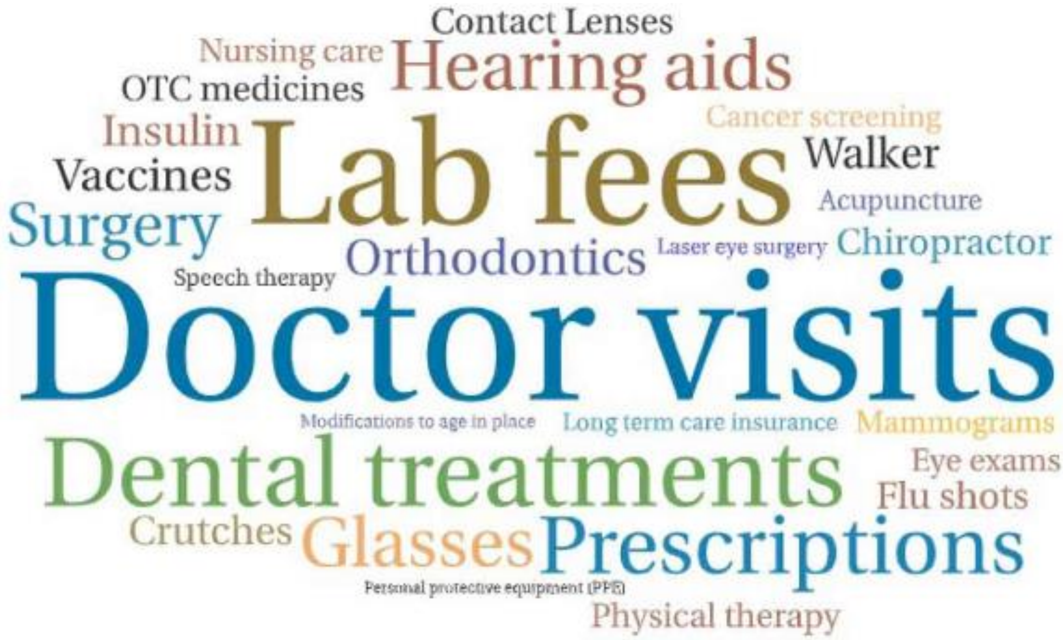
Healthcare costs can represent a large portion of a retiree's spending. HSAs allow people to accumulate funds during their working years to help cover these expenses in retirement.

Que. How much can a retired couple over age 65 expect to spend on healthcare costs?
Ans: According to the Fidelity Retiree Health Care Cost Estimate, an average retired couple age 65 in 2021 may need about $300,000 to cover healthcare costs in retirement.

Distributions

Distributions from an HSA used to pay for qualified medical expenses, as defined by the IRS, are tax free. Qualified medical expenses include the costs to diagnose, treat, or prevent disease and the cost of equipment, supplies, and devices used for these purposes. Expenses for mental health treatment and the cost of transportation to obtain medical care are also considered qualified medical expenses.

What's considered a qualified medical expense?



Most institutions that administer HSAs provide account owners with a debit card to pay for medical expenses. An account owner can also make a withdrawal from an HSA to reimburse expenses paid for out of pocket, as long as the expense was incurred *after* the HSA was established.
Sometimes account owners may need to access the funds in the HSA after paying for qualified medical expenses using funds outside the HSA. Account owners can reimburse themselves from the HSA at that time, even if years later, using receipts from the earlier medical expenses. In such a case, the reimbursement is still a tax-free distribution.

Example: Susie Sosa paid for her daughter's orthodontist bills with funds outside of her HSA. Five years later, she decided to submit her receipts for the orthodontist bills for reimbursement from her HSA. Because the expenses occurred after her HSA was in place and Susie has the receipts for the expenses, she will be reimbursed for her payments in a tax-free distribution.

Distributions in Retirement

An HSA owner is no longer allowed to contribute to the account once the owner is enrolled in Medicare or is no longer participating in an HDHP. However, the individual still owns the HSA, and the funds in the account may continue to accumulate earnings. In addition, the account owner can take tax-free withdrawals as needed to pay for qualified medical expenses. An HSA can be a valuable asset in retirement to pay for long-term care insurance premiums, skilled nursing costs, and even modifications to a home to facilitate aging in place.

Taxation of Distributions

What if an account owner withdraws money from an HSA to pay for something other than qualified medical expenses? Distributions from an HSA that are not used to pay for qualified medical expenses are subject to taxation and a 20% additional penalty on the distribution unless the individual is

- Age 65 or older
- Disabled
- Deceased

For those age 65 and older, HSA distributions for nonmedical purposes are similar to withdrawals from a traditional IRA in that they are subject to ordinary income taxes but not the additional penalty for premature distributions.

It is important to note that HSAs are not subject to the required minimum distribution (RMD) rules. In other words, an account owner can keep the balance in the account indefinitely.

Examples: Peter Palmer, age 50 and not disabled, took a $4,000 distribution from his HSA to pay for home repairs. Because the distribution was not used to pay for qualified medical expenses, it will be subject to federal and state income taxes, plus an additional 20% penalty of $800 (0.20 x $4,000).

If Peter had instead used the money from the HSA to pay for qualified medical expenses, the entire $4,000 distribution would have been tax free.

Rashida Reynolds, age 70, took a $10,000 distribution from her HSA to pay for travel and other nonmedical expenses. The distribution will be subject to income taxation, but the additional 20% penalty will not apply because Rashida is over age 65.

Beneficiaries

When an HSA owner dies, the treatment of the account depends on the designated beneficiary. If the beneficiary is

- A spouse, the account will be treated as the spouse's HSA, and the spouse retains the tax advantages associated with the account.
- A nonspouse, the account will cease to be an HSA, and the balance of the account will be treated as taxable income to the beneficiary in the year of the account owner's death. The taxable amount can be reduced by payments made for qualified medical expenses of the decedent within one year of death.

HSAs Compared to Traditional and Roth IRAs

HSAs combine some of the features of traditional and Roth IRAs, making them an excellent vehicle for tax-efficient retirement savings.

	Traditional IRA	Roth IRA	HSA
Contribution Eligibility	Must have taxable compensation	Must have taxable compensation and have income below specified thresholds	Must be enrolled in HDHP; no income limits
Individual Contributions	• Pretax • Subject to FICA	After-tax	• Pretax • Exempt from FICA if made through payroll deductions

Contributions by Others	Not allowed	Not allowed	Allowed
Annual Contribution Limit (2023)	$6,500	$6,500	$3,850 single/$7,750 family
Catch-up Contributions	$1,000 (age 50+)	$1,000 (age 50+)	$1,000 (age 55+)
Investment Earnings	Tax deferred	Tax free	Tax free
Taxation of Distributions	Taxable	Tax free, if a qualified distribution	Tax free, if used for qualified medical expenses
Penalty on Distributions (Unless Exception Applies)	10% on distributions before age 59½	10% on portion of distributions attributed to earnings if the account owner has not reached age 59½	20% on distributions for nonmedical expenses before age 65
Subject to Required Minimum Distribution Rules	Yes	No	No

- While distributions for nonmedical expenses by HSA owners who are at least 65 years old are subject to taxation, these distributions are not subject to the additional 20% penalty.

- An HSA owner is no longer allowed to contribute to the account once the owner is enrolled in Medicare or is no longer participating in an HDHP. However, the individual still owns the HSA and can make tax-free withdrawals from it to pay for qualified medical expenses.

- A spouse who inherits an HSA can treat the account as the spouse's own HSA and take tax-free distributions to pay for qualified medical expenses. If a nonspouse inherits an HSA, the account ceases to be an HSA, and the account balance is taxable.

Conclusion

In this module, you learned how individual retirement arrangements and health savings accounts can be used to help individuals save for retirement. Individuals should weigh the features and benefits when considering the best fit for their goals and circumstances.