PATRICK H. YANKE, CFP® | Financial Planning

Understanding Tax-Advantaged Accounts

Tax deferral is powerful for long-term wealth accumulation. There are accounts authorized by IRS code to help. Each has its purpose. It's important to understand them and how they may be used.

UNDERSTANDING IRAS

There are two major types of IRAs – traditional and Roth. Both allow annual combined contributions of up to $7,000 in 2024 and taxpayers aged 50 or older may make additional "catch-up" contributions of up to $1,000.

Generally, participants must have at least as much earned compensation as the amount of the IRA contribution. When married and filing jointly, spouses can also contribute to an IRA even if they do not have their own taxable compensation—provided the total contribution amount does not exceed joint compensation for the year.

Both traditional and Roth IRAs feature tax-sheltered growth of earnings and typically offer a wide range of investment choices.

TRADITIONAL IRAS

A key benefit of a traditional IRA is the potential ability to take a tax deduction in the year of contributions. Tax-deductible contributions lower taxable income for the year, reducing overall income tax obligations.

The portion of distributions that represent deductible contributions and earnings will be subject to income tax. In addition, a 10% early-withdrawal penalty is assessed if the account owner is under age 59 1/2, unless they meet an exception. For details on exceptions, please visit the IRS website.

Tax deferral continues on a traditional IRA only until participants must take required minimum distributions (RMDs). RMDs are determined by the size of the IRA and the age of the account holder.

ROTH IRAS OFFER TAX-FREE INCOME

Contributions to a Roth IRA are not tax deductible—only after-tax dollars may be invested in a Roth IRA. However, the primary benefit of these types of IRAs is that withdrawals will be completely free of federal (and possibly state) income tax—including both contributions and investment earnings—as long as conditions are met.

Not everyone can set up a Roth IRA and even those who can may not qualify to take full advantage of it. The ability to contribute to a Roth IRA depends upon MAGI and income tax filing status.

To be eligible for tax-free distributions, investors must hold the Roth IRA for at least five years and be at least age 59 1/2. Distributions from an inherited Roth IRA are always tax-free. Additional conditions can be found on the IRS website.

The ability to withdraw funds with no taxes or penalty is a key strength of the Roth IRA. Even nonqualified distributions will be taxed (and possibly penalized) only on the investment earnings portion of the distribution, and then only to the extent that a distribution, plus all previous distributions, exceed the total amount of all contributions made to the account.

HEALTH SAVINGS ACCOUNTS

Those eligible to participate in Health Savings Accounts (HSA) find a triple tax-advantaged account. Contributions are tax-deductible, earnings within the accounts are tax-deferred, and distributions—if used for qualified health expenses—are tax-free!

Although focused on qualified health expenses, these accounts may be a powerful part of a long-term portfolio. Statistically, people have greater healthcare needs in retirement. An HSA provides a tax-free account for this purpose and the funds may even be used for Medicare premiums!

WHICH IS BETTER?

An objective measure to choose between traditional or Roth IRAs is income. Those in high tax brackets will benefit the most from a current year tax deduction offered by a traditional IRA. Those in lower tax brackets may benefit the most from tax-free income in retirement. For those in middle tax brackets, it's a judgement call factoring in expectations for future income and tax rates. Those eligible to participate in HSAs will benefit from the only triple tax-advantaged account.

Talk to a financial professional to get individualized recommendations.

Patrick Yanke is a Raleigh-based financial advisor. Opinions expressed here are mine and not necessarily those of Raymond James. The information is not a complete summary or statement of all data necessary for making an investment decision and does not constitute a recommendation. Please consult with appropriate professionals for tax and legal issues. www.yankefinancial.com.