Tax-Deferred vs Tax-Exempt

What is tax-deferred?	**Tax Advantages Today.** A tax-deferred plan is an investment account that allows a taxpayer to postpone paying income taxes on the money invested until it is withdrawn, generally after retirement.
What is tax-exempt?	**Tax Advantages in the Future.** Tax-exempt accounts have no immediate tax benefit, they have a tax benefit in the future. You can contribute to the account with after-tax money and pay the full amount of income taxes in the current year.

What plan is right for you?

When considering what plan is right for you, you first must determine what tax bracket you are in.

- If you are in a lower tax bracket, a tax-exempt plan may be more suitable for you. You could possibly be in a higher tax bracket at retirement, which would put you in a higher tax rate status. This could cause you to pay more taxes in the future.
- Tax payers in a higher income tax status would be more suitable in a tax-deferred plan. You may be in a lower tax bracket at retirement causing you to pay less taxes in the future.

Are you required to pay taxes on the earning?

- Tax-deferred plans require you to pay taxes on the earnings, such as capital gains or interest
- In tax-exempt plans the taxes are paid in the current year so no taxes are paid on your retirement funds

Are there income limits on who may contribute?

Both traditional and Roth IRAs have income limits. Employer based plans like 401(k) or Roth 401(k)s are way to eliminate the worry of income changes year-to-year. They allow you to contribute more regardless of your income level.

Common types of tax-deferred plans

- Traditional IRA, SEP IRA
- Employer Sponsored 401(k) or Solo 401(k)
- Profit Sharing
- Variable or Fixed Annuities
- Non-profit 403(b) or Government 457 Plans

Common types of tax-exempt plans

- Roth 401(k)
- Roth IRA

Benefits of tax-deferred plans

- Each year's taxable earned income is reduced by the amount contributed to the account. The individual's federal taxes owed are lowered for that year due to this.
- The individual's money is invested in their choice of mutual funds or other types of investments, with a balance that grows steadily until retirement.
- The money invested grows over time and the individual draws the funds for income after retiring.

Benefits of tax-exempt plans

- Once you contribute money into the account, you will never pay taxes on it again.
- The money grows tax-free in the account, and you can withdraw it tax-free during retirement, if you meet all of the distribution requirements.
- No Required Minimum Distributions (RMDs)

Withdrawing money from your plan

- Some plans provide loan options.
- If you make an early withdrawal from your plan (before age 59 1/2), the IRS will typically charge you a 10% fee for early withdrawals, on top of regular income tax, unless you have a qualified exception.
- Because you have already paid taxes on your contributed money, withdrawals can be taken tax-free from a Roth during retirement.

Qualified Exceptions for withdrawing money from your plan

- **The Rule of 55** - If you retire, quit or lose your job in the calendar year you turn 55, you may take early withdrawals without penalty. If you have a tax-deferred plan, you will still be required to pay taxes, same as in retirement.
- **Substantially Equal Periodic Payments** - If you need to take your money out before you are 55, you can cash out your 401(k) early by taking yearly withdrawals for at least 5 years, or until you reach the age of 59 1/2, whichever is longer. Note, if you reach age 55 and choose this option, you will still be required to take substantially equal periodic payments for at least 5 years.
- **401(k) Hardship Withdrawals** - The funds from your principal balance, not the gains or interest, can be used for financial hardships: Medical bills and/or insurance, Buying a house that will be your primary residence, Paying for education expenses, Covering funeral expenses, Preventing foreclosure, and Making necessary home repairs. Not all 401(k) plans allow for hardship withdrawals, and those that do may limit what is covered.
- **Required Minimum Distributions (RMDs)** - When you need to start taking your RMDs depends on your birth year. You want to make sure you calculate your RMD in advance, otherwise you could face a 50% penalty on whatever you failed to appropriately take out.

What are Catch-up Contributions?

There is a limit set to the amount you can put into your retirement savings account. These limits are enforced by your plan administrator, but set by the IRS. Catch-up contributions allow older taxpayers to contribute more to accelerate their retirement savings. The best way to determine your catch-up limits is to talk to your financial advisor.

For more information about retirement savings account, please contact our office.