WILMINGTON TRUST

MEMBER OF THE M&T FAMILY

Understanding the Tax Treatment of Retirement Plans

Make your retirement planning as tax-efficient as possible

MATTHEW J. MANCINI, CFP®, CHFC®, AEP®

Wealth Team Leader
& Senior Wealth Planner

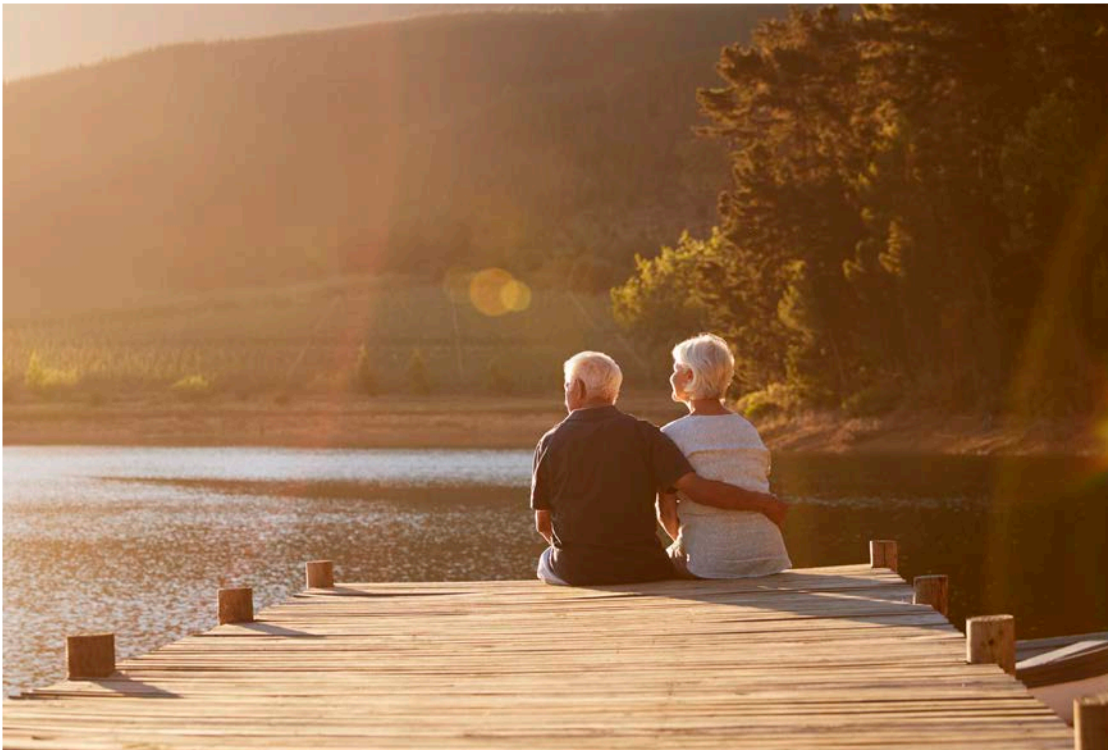
CAILIN MACLEAN, CFP®

Senior Wealth Planning Analyst

Key points

- Qualified savings plans and retirement accounts continue to offer taxpayers several options for saving for retirement
- There are many additional opportunities and considerations for taxpayers to be mindful of in order to take full advantage of planning for retirement in a tax-efficient manner
- Legislation passed in 2019, and again in late 2022, created some changes to the retirement plan landscape for individuals and small businesses

©2023 M&T Bank and its affiliates and subsidiaries. All rights reserved.



Over the past 50 years, there has been a dramatic shift in funding retirement for the average American. Most people rely on savings and few have pensions available to them. One of the most common ways to save is through a retirement savings plan offered by your employer; the most common is the 401(k) plan. These plans are designed to incent you to save every year, often with contributions from your employer, with the goal of maintaining a comfortable lifestyle in retirement.

Understanding defined contribution plans

A 401(k) plan is one kind of defined contribution plan. In a defined contribution plan, the employer, employee, or both make regular contributions to the plan. The money is invested, and taxes are deferred until withdrawal. The retirement benefit is the balance in the account. Other types of defined contribution plans include the 403(b) plan, simplified employee pension (SEP), and savings incentive match plan for employees (SIMPLE). In general, both employers and employees can contribute to these plans to a maximum of $66,000 (in addition to a "catch-up" contribution, if eligible). Certain plan designs, such as including a profit-sharing feature, can help self-employed and small business owners build up their own retirement nest eggs and provide options for the deferral of taxable income, as well as enhanced employee benefit packages.

"Defining" defined benefit plans

A defined benefit plan, as the name suggests, is designed to fund a certain level of retirement income at a future date. It is funded by annual contributions based on the individual's age, income, length of time until retirement, and rate of return on the fund's investments. The contribution amount is determined each year by actuarial calculations. For 2023, the funded benefit payable at

Continued

 ©2023 M&T Bank and its affiliates and subsidiaries. All rights reserved.

retirement can be as much as $265,000, based on up to $330,000 of annual compensation. The plan is funded entirely by employer contributions, which are generally 100% tax-deductible. For a business owner close to retirement age, the required contribution can be considerable, along with the tax deduction. Annual contributions are mandatory, and if the business has other employees, contributions have to be made for them, too. A defined benefit plan is more costly than many retirement plans but allows for greater contributions than most other plans.

Cash balance plans. An alternative to a traditional defined benefit plan is the cash balance plan. It is a type of defined benefit plan that also has features of a defined contribution plan. The benefit is represented as an account balance rather than a monthly pension. (This is hypothetical; there are no actual individual accounts.) At retirement, a participant can take an annuity based on the account balance or, if the plan permits, a lump sum, which can be rolled into an individual retirement account (IRA) or another qualified plan. Like traditional defined benefit plans, a cash balance plan can allow for significant contributions that are tax-deductible to the employer. The contribution limit varies by the age of the participant, and for those nearing retirement age, it can be over $200,000. As it is a type of defined benefit plan, annual employer contributions are mandatory, while employee contributions are not permitted. Contributions must be made for all employees, but the plan can be designed using a class-based benefit formula, which allows different benefit credits for different classes of employees. Given this, business owners can receive a higher benefit than rank-and-file employees, which can make it an attractive retirement planning vehicle from a savings and tax deductibility perspective.

The timing for tax deductibility of various retirement planning vehicles can vary. In the case of a cash balance plan, it must be established prior to year end for your contribution to be counted for the current tax year and to receive the benefit of deferring the recognition of income; however, you have until your tax filing date to fund the plan.

Individual retirement accounts

Traditional IRAs allow for less in annual contributions and remain subject to income limitations for determining deductibility when the individual or his or her spouse is covered by an employer-sponsored plan. The current contribution limit is $6,500 per year, with a $1,000 “catch-up” contribution, which is an additional contribution allowed by people aged 50 or older. The Secure Act 2.0, passed in 2022, adjusts this catch-up contribution limit for inflation in increments of $100, effective starting in 2024. The IRA contribution limit applies to traditional and Roth accounts together; the combined contributions cannot exceed the limit. Roth IRA contributions are not deductible, but contributions to a traditional IRA may be, depending on circumstances. If neither the IRA owner nor the spouse is an “active participant” in a retirement plan at work, the entire contribution is tax-deductible. If the individual or his or her spouse does have coverage at work, IRA deductibility is phased out over a range of income. If only one spouse is employed, the working spouse can also make up to a full ($6,500 or $7,500) contribution to a spousal IRA, provided he or she has sufficient earned income.

The IRS has a strict definition of being an “active participant” in an employer plan. For plans such as SEPs, 401(k)s, profit sharing, etc., a person is an active participant if any contribution or forfeiture allocation is made, no matter the amount and regardless of whether or not the person is vested in the contribution. For a defined benefit plan, one is an active participant if eligible under the rules of the plan, even if the person has declined to participate. If a person is an active participant for any part of the year, he or she is considered an active participant for the entire year. And, depending on the type of plan, timing is also a factor: for some plans, participation is considered in the year the deposit is made, even if it is for a prior year, while other plans consider an individual an active participant in the year for which the contribution is made, regardless of when it is actually deposited.

Continued

©2023 M&T Bank and its affiliates and subsidiaries. All rights reserved.

Roth IRAs: Tax strategies to consider

The potential for higher tax rates in the future emphasizes the importance of a tax-free source of income during retirement. Similar to health savings accounts (HSAs) for medical expenses, which are discussed below, a key component of the retirement income equation can be satisfied with tax-free funds from a Roth IRA. With a Roth IRA, there is no tax deduction for contributions, but if certain conditions are met, withdrawals are tax free, including the growth in the account. The account (or another Roth for the same owner) has to have been open for at least five years, and the individual must be aged 59½ or above to receive withdrawals on earnings free of income tax.

Contributions can be withdrawn without tax at any time, but there is a 10% penalty for withdrawals before 59½, with a few exceptions. These exceptions include withdrawals for buying a first home or for education expenses. The penalty also does not apply after disability of the account owner.

Since the Roth IRA can be a 100% tax-free source of income/investment, in addition to the benefits it can offer during retirement, it can also serve as an effective legacy planning tool. By preserving the Roth IRA for as long as possible, you are providing the opportunity for maximum growth to an account that can be 100% free from tax, provided the required conditions are met.

There are a number of reasons to consider a Roth if you:

- **Are not eligible for deductible IRA contributions**
- **Expect higher taxes in retirement**
- **Do not want/need required distributions**
- **Want to leave tax-free money for heirs**

Converting a traditional IRA to a Roth IRA. Given the long-term benefits that Roth IRAs can provide in planning, conversions from traditional IRAs to Roth IRAs should be evaluated in the scope of one's overall income tax and estate planning. Since 1997, IRA conversions from traditional IRAs to Roth IRAs have been permitted, although initially these conversions were subject to income limitations. Those limitations were eliminated in 2010, and today, all taxpayers are eligible to convert funds from a traditional IRA to a Roth IRA. When a conversion is done, income tax must be paid on the converted amount.

For traditional IRA accounts, the current tax laws make the opportunity to convert balances to Roth IRAs even more attractive, especially if you are already retired with a lower income level. The cost of a conversion is less than in previous years due to lower marginal tax rates, at least for now. The current tax rates for the individual taxpayer are set to revert to older, higher rates in 2026, or perhaps sooner under the current administration in the White House, and therefore conversions should be evaluated now while tax brackets are low. Also, today's higher standard deduction (which essentially doubled for most individuals in 2018) may enable some taxpayers to deduct more than in the past, giving them a lower taxable income base and perhaps keeping them in a lower tax bracket. So even though there is an upfront tax when a conversion takes place, under current tax law it could be cheaper than in the past. Conversions can also be phased in over multiple years so a structured conversion program can help a taxpayer to stay within a lower bracket each year.

Another legacy planning opportunity for wealthy families is to utilize the annual gift exclusion (currently $17,000 per year, per individual) to help a parent pay the tax on a conversion as part of a generational plan. After conversion, if the Roth owner and spouse are not dependent on the asset for income, consideration should be given to naming younger family members (i.e., children or grandchildren) as beneficiaries of the IRA rather than a spouse. This strategy may have unintended consequences however, as the child or grandchild may be subject to accelerated distributions from the Roth IRA when they inherit it, albeit tax free. Including this type of strategy as part of a generational legacy plan has additional benefits given today's tax environment. The generation-skipping transfer (GST) tax exemption is currently $12.92 million per individual. This increased exemption amount provides additional opportunities to skip a generation to bypass taxation at the second generation and provide for grandchildren and future generations either outright or in trust.

Elimination of the right to "recharacterize." Although Roth conversions can no longer be recharacterized, recharacterization is still permitted with respect to current contributions, particularly when it is to fix a mistaken IRA contribution, as long as it is done within the same tax year of contribution to the IRA. Since there is an income limit to qualify

Continued

 ©2023 M&T Bank and its affiliates and subsidiaries. All rights reserved.

for making Roth contributions, if you contribute to a Roth IRA and realize after the fact that your income level makes you ineligible, then you can recharacterize the contribution to a traditional IRA. (The reverse is also true where contributions may be recharacterized from a traditional IRA to a Roth IRA.)

In the case of ineligibility due to income level, a common strategy used by high income tax payers is the "back door" Roth IRA, where you make nondeductible contributions to a traditional IRA and then convert within the same tax year to a Roth IRA. For taxpayers who are precluded from making contributions directly to a Roth IRA due to income phase-out levels, this allowance provides an opportunity for anyone to build up a source of tax-free income as part of his or her retirement or legacy plan.

The SECURE Acts

In December of 2019, the Setting Every Community Up for Retirement Enhancement (SECURE) Act (Act), was signed into law. In December of 2022, an additional version of this Act (SECURE Act 2.0) was also signed into law. Both provide for major changes to the retirement landscape in an attempt to modernize the country's retirement system. Some of the more notable changes include:

- Elimination of the "stretch" provisions for most non-spouse beneficiaries of IRAs and defined contribution plans
- Required minimum distribution age increased from 70½ to either 72, 73, or 75 depending on your year of birth
- No maximum age restriction on contributions to IRAs provided you have earned income
- The ability for employers to characterize matching contributions to retirement plans as Roth
- Mandatory Roth treatment of "catch-up" contributions to employer plans for higher income earners
- The elimination of required distributions from Roth employer retirement plans
- The option for employers to contribute to a retirement plan for employees who are paying student loans
- Increased maximum tax credit available to a small business for establishing a company-sponsored retirement plan, such as a 401(k), 403(b), SEP IRA, or SIMPLE IRA

These provisions do not all take effect at the same time, so it is important to clarify with your financial and tax advisors on when these new rules go into effect.

Strategies for business owners: Using retirement plan contributions to take full advantage of the section 199A deduction

Under Internal Revenue Code (IRC) section 199A, the tax law allows for a 20% qualified business income (QBI) tax deduction to pass-through entities such as sole proprietorships, partnerships, LLCs (taxed as a partnership), and S corporations. There are limits to the deduction that phase in beginning at $364,200 in taxable income for married filing jointly (MFJ) taxpayers ($182,100 for all other filers). The deduction completely phases out at $464,200 for MFJ (or $232,200 for all other taxpayers) when the business is classified as a "specified service business." For non-service businesses, they are subject to the same income thresholds as the service businesses; however, if they are over the income thresholds, they can still be eligible for a 199A deduction if their business pays W-2 wages to employees and/or has basis in depreciable property for the business. In these cases, the 199A deduction could be a percentage of those numbers, and not a percentage of the QBI. This alternative to the QBI deduction is not available to the service businesses.

For business owners with high incomes who exceed these thresholds, establishing tax-advantaged retirement plans and maximizing contributions to them, as well as HSAs, if applicable, can provide an opportunity to reduce taxable income to a range where the business owner can take advantage of the 199A deduction while also saving more for retirement and diversifying assets away from the business. In this case, a defined benefit or a cash balance plan may be an option.

Utilizing health savings accounts

HSAs continue to grow in popularity, and while not always classified as retirement savings vehicles, these accounts can provide an attractive upside to taxpayers while working and during retirement. Contributions to HSAs are fully tax-deductible, and withdrawals at any time are tax free if used for qualified medical expenses.

If HSA money is used for non-medical expenses, income tax on the amount must be paid, as well as a 20% penalty until age 65. However, once you reach age 65, the penalty no longer applies.

If properly planned for by using HSAs, the retiree can avoid using 401(k) or traditional IRA funds for medical expenses where those funds are 100% taxable and can be subject to penalties if taken before age 59½. The HSA can be even more attractive

Continued

©2023 M&T Bank and its affiliates and subsidiaries. All rights reserved.

than a Roth IRA when used for medical expenses, as Roth contributions do not get an income tax deduction, although withdrawals are tax free when they meet certain criteria.

The HSA may be the optimal retirement planning tool to pay the retiree's medical expenses. The taxpayer receives both a tax deduction on the monies contributed into the account as well as tax-free withdrawals to use for medical expenses.
Since only taxes are due (no penalties) on withdrawals for non-medical expenses at age 65, there is typically little risk if the account becomes overfunded relative to medical expense needs, since the account operates like a traditional retirement account at age 65, where withdrawals for non-medical expenses are subject only to ordinary income tax (no penalty). Given these advantages, for those who can afford to, a good strategy is to use non-HSA funds for current medical expenses when possible and fund the HSA to the maximum allowable contribution each year (subject to certain criteria*). There is no required timing for distributions so the HSA can grow until retirement, or longer, tax free or tax deferred (depending on ultimate use).

The qualified charitable distribution

The qualified charitable distribution (QCD) permits individuals aged 70½ or older to exclude up to $100,000 of distributions from gross income each year by making a QCD from their IRA directly to a qualified charitable organization. This law was made permanent by the Protecting Americans from Tax Hikes Act of 2015 and, for those individuals that historically did not itemize their deductions but used the standard deduction, it gave them the benefit of the "charitable deduction" by excluding the qualified charitable distribution from income. The SECURE Act 2.0, passed in 2022, also expanded the use of this strategy by allowing one-time distributions to a charitable remainder trust (with certain limitations), and for the first time, indexed the $100,000 annual limit with inflation beginning in 2024.

Given that a larger portion of taxpayers may find it more advantageous to take the standard deduction over itemizing as a result of today's tax law, the QCD is one way for older donors to continue to get the benefit of charitable giving whether or not they are itemizing their deductions. By taking advantage of the QCD, you could receive a full income tax benefit for the amount given to charity, as this amount will not be recognized as taxable income. Any distribution above the amount given to charity would be subject to ordinary income tax as usual.

By using QCD the taxpayer over age 70½ can effectively get both the benefit of the charitable deduction and the larger standard deduction. For a couple over age 65, the standard deduction is $30,700. For a charitably inclined individual over age 70½, there is currently no downside to this strategy, and in fact, it may become the optimal way for many seniors to give to charity from an income tax perspective.

It's important to continue to work with your advisors to be sure your retirement planning is up to date in light of the current tax law, potential changes that could be on the horizon, and to take advantage of any additional savings opportunities.

* *There are several criteria to qualify for contributions to a health savings account, including the requirement that you must be covered by only a high-deductible health plan (HDHP). There are annual contribution limits based on HDHP coverage (self-only or family) and HSAs allow for catch-up contributions for individuals aged 55 and older. HSAs cannot be used to pay for medical insurance premiums but can be used to pay for Medicare premiums (but not Medigap) as well as certain long-term care insurance premiums. For more information on the HSA, please read Retirement Saving Strategies for Corporate Executives.*

Continued

©2023 M&T Bank and its affiliates and subsidiaries. All rights reserved.

MATTHEW J. MANCINI, CFP®, CHFC®, AEP®

Wealth Team Leader & Senior Wealth Planner

716.848.7564
mmancini@wilmingtontrust.com

As part of the Wilmington Trust Emerald Family Office & Advisory® team, Matthew is responsible for developing customized wealth management strategies and financial plans for prominent individuals, families, and business owners. He works closely with other professional and family advisors to analyze financial positions and develop plans to help clients achieve future personal and financial goals.

Matthew holds a bachelor's degree in finance from Canisius College and earned the CERTIFIED FINANCIAL PLANNER™ designation in 2011, and the CHARTERED FINANCIAL CONSULTANT® designation in 2015 from The American College. Matthew has also received the ACCREDITED ESTATE PLANNER® designation from the National Association of Estate Planners and Councils in 2019. Matthew is an active member of the Financial Planning Association of Western New York and the Western New York Estate Planning Council.

CAILIN MACLEAN, CFP®

Senior Wealth Planning Analyst

410.244.4417
cmaclean@wilmingtontrust.com

As part of the Wilmington Trust Emerald Family Office & Advisory® team, Cailin is responsible for supporting members of the Advanced Financial Planning team with the development of customized wealth management and financial plans for prominent individuals, families, and business owners throughout the country. She works closely with other professional and family advisors to analyze financial positions and assist in developing plans to help clients achieve future personal and financial goals.

Cailin joined Wilmington Trust in 2018. She holds a bachelor's degree in economics from Hobart and William Smith Colleges and earned her Certified Finanancial Planner™ designation.

Wilmington Trust is a registered service mark used in connection with various fiduciary and non-fiduciary services offered by certain subsidiaries of M&T Bank Corporation including, but not limited to, Manufacturers & Traders Trust Company (M&T Bank), Wilmington Trust Company (WTC) operating in Delaware only, Wilmington Trust, N.A. (WTNA), Wilmington Trust Investment Advisors, Inc. (WTIA), Wilmington Funds Management Corporation (WFMC), and Wilmington Trust Investment Management, LLC (WTIM). Such services include trustee, custodial, agency, investment management, and other services. International corporate and institutional services are offered through M&T Bank Corporation's international subsidiaries. Loans, credit cards, retail and business deposits, and other business and personal banking services and products are offered by M&T Bank, Member FDIC.

Wilmington Trust Emerald Family Office & Advisory® is a registered trademark and refers to wealth planning, family office and advisory services provided by Wilmington Trust, N.A., a member of the M&T family. Wilmington Family Office is a service mark for an offering of family office and advisory services provided by Wilmington Trust, N.A.

This article is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service. It is not designed or intended to provide financial, tax, legal, investment, accounting, or other professional advice since such advice always requires consideration of individual circumstances. If professional advice is needed, the services of a professional advisor should be sought. There is no assurance that any investment, financial or estate planning strategy will be successful. These strategies require consideration for suitability of the individual, business, or investor.

Wilmington Trust is not authorized to and does not provide legal or accounting advice. Wilmington Trust does not provide tax advice, except where we have agreed to provide tax preparation services to you. Our advice and recommendations provided to you are illustrative only and subject to the opinions and advice of your own attorney, tax advisor, or other professional advisor.

The information in this article has been obtained from sources believed to be reliable, but its accuracy and completeness are not guaranteed. Opinions, estimates, and projections constitute the judgment of Wilmington Trust and are subject to change without notice.

Third-party trademarks and brands are the property of their respective owners.

©2023 M&T Bank and its affiliates and subsidiaries. All rights reserved. AMP-3720 230119 VF