Your Firm LLC

Finding the Right Type of IRA for You

While saving for retirement is often associated with 401(k) plans, the IRA or Individual Retirement Arrangement provides important options for both individuals and small business owners. This document reviews the basics of IRA plans and their contribution limits.

Types of Individual Retirement Plans

Traditional IRAs

Traditional IRAs are plans that individuals open and fund themselves without their employer's involvement. Individuals can contribute a portion of their annual income subject to certain limitations. The individuals receive an income tax deduction for contributions to the plan thereby reducing their tax burden for the year in which the contributions are made. The IRA balance can grow tax-deferred and then you pay taxes once you make a withdrawal.

It is important to note that contributions are not deductible if you have a retirement account through your employer and earn more than $74,000 annually. It is also worth noting that as of January 1, 2020, there is no longer an age limit for those who wish to contribute to a traditional IRA.

Roth IRAs

Like the traditional IRA, a Roth IRA is a retirement account that you open and fund yourself.

Contributions to Roth IRAs are made after-tax, so contributions are not tax-deductible. However, your balance can grow tax-free, and you do not have to pay taxes when you withdraw funds during retirement. A Roth IRA is often beneficial for individuals who are in a lower income tax bracket when they contribute funds to the IRA. If your income tax bracket increases over your lifetime, you can potentially save money with a Roth IRA. You will pay taxes on your retirement funds while you are within the lower income bracket, and not have to worry about taxes upon withdrawal, when you might be in a higher income tax bracket.

Payroll Deduction IRAs

A payroll deduction IRA is an IRA, either traditional or Roth, that is funded by the employee through automated payroll deductions. With this option, the employee sets up an IRA with their financial institution and then authorizes their employer to make the payroll deduction directly to that financial institution. The employer has no administrative responsibilities for the plan but should ensure that the option is offered to everyone.

This is a great option for employees who do not have access to another type of retirement plan, and it can be used by businesses of any size, including those who are self-employed. The drawback is that only employees can contribute to this form of IRA, meaning there is no employer matching.

Since a payroll deduction IRA can be either a Roth IRA or Traditional IRA, taxation differs depending on the plan as we discussed previously.

SIMPLE IRAs

Savings Incentive Match Plans for Employees also known as SIMPLE IRAs are set up by employers. Employers are required to contribute to the plan on behalf of employees and employees have the option of contributing their own funds as well. The benefits for employees are similar to other retirement plans. From an employer's standpoint though, SIMPLE IRAs make the most sense for small businesses with fewer than 100 employees and are not able to offer a 401(k). Small businesses can use this type of plan to supplement employee compensation, in a tax-deductible manner, making their business more attractive to qualified candidates.

Like most other retirement plans, contributions are tax deductible, but you will have to pay taxes on withdrawals made during retirement. There are limits on the amount an employee can contribute in a year; however, employers must contribute 2-3% in funds to the plan for each employee.

Simplified Employee Pension (SEP)

The Simplified Employee Pension or SEP, is specifically for a self-employed individual or small business owner who is looking to contribute to their own plan. SEPs enable you to contribute significantly more than an IRA, are typically cheaper to administer, and are tax deductible. The only catch is that there may be extensive paperwork involved with setting up the SEP, so you will want to consult with an experienced tax advisor. Contributions are tax deductible and grow tax-deferred, but are taxable on withdrawal.

Contribution Limits and Early Withdrawal Penalties

Each type of retirement plan has certain contribution limits and may be subject to income restrictions as defined by the IRS. Likewise, if you need to take an early withdrawal, you may face penalties.

Traditional and Roth IRAs

The combined limit that individuals may contribute to all of their traditional and Roth IRAs is $6,000 per year for those under age 50 and $7,000 per year for those 50 and older. While there are no income limitations for the traditional IRA, there are income limitations for tax-deductible contributions if you are covered by another plan offered by your employer such as a 401(k). The maximum income limitations for 2021 are:

- $76,000 for single filers and heads of household.
- $125,000 for married couples filing jointly.
- $100,000 for married couples filing separately.

In order to contribute to a Roth IRA in 2021, your income cannot exceed:

- $140,000 for single tax filers and heads of households.
- $208,000 for married couples filing jointly.
- $100,000 for married couples filing separately.

In regard to early withdrawal, there is a 10% penalty for early withdrawals prior to age 59 and a half for both types of plans.

Payroll Deduction IRA

Since a Payroll Deduction IRA can be either a traditional or Roth IRA, the contribution limits are the same as these IRAs: $6,000 if you're under age 50 and $7,000 if you're 50 or older. The employee would be subject to the same income limits, and there is also a 10% penalty for early withdrawals made before age 59 and a half.

SIMPLE IRA

Employees who participate in a SIMPLE IRA can contribute up to $13,500 for 2021. If they participate in any other employer plan during the year, the combined limit that they can make to all of the plans they participate in is limited to $19,500 in 2021.

In addition, those who are age 50 or over at the end of the calendar year can make catch-up contributions of an additional $3,000 through 2021. With the SIMPLE IRA, early withdrawals before age 59 ½ will incur a 10% penalty and withdrawals made within the first two years of plan participation are penalized at 25%.

Simplified Employee Pension

A Simplified Employee Pension plan has one of the most flexible contribution limits. SEP plans that are not Salary Reduction SEP-IRAs only allow employer contributions and are not reduced by the contributions you or your employer make to your employer's SIMPLE IRA plan. Employers can contribute up to $58,000 or 25% of annual income for each employee, whichever is lower. For a self-employed individual, contributions are limited to 25% of your net earnings from self-employment, not including contributions for yourself, up to $58,000 for 2021.

If your business sponsors another defined contribution plan in addition to your SEP plan (for example, a profit-sharing plan or a 401(k) plan), then your contributions for yourself to all these plans may not exceed 25% of your net earnings from self-employment (not including contributions for yourself), up to $58,000 for 2021.

Note that salary deferrals are not subject to the 25% limit and catch-up contributions are not included in the $58,000 limit. Aside from the different contribution limits, an SEP follows the same rules as an IRA.

Next Steps

This whitepaper is meant to provide you with an overview of the types of IRA plans you can choose from and is not meant to be a substitute for expert advice. Choosing the right plan and ensuring that you comply with all of the IRS regulations can be a challenge. Please give us a call for help with any questions you may have.

About Your Firm LLC

We have hand-picked a team with tax, auditing, accounting, business and management advisory expertise in a multitude of fields, including healthcare, professional-services firms, commercial contractors, home builders, real estate companies, manufacturing and distribution companies, dealerships, non-profit organizations and pension funds.

We have the expertise and the resources to provide not only the critical services you need during these evolving economic times, but also, importantly, to build for the future. Our strategic alliances with professional organizations across the country allow us to bring our clients the talent and expertise of national firms with the high-touch service of a local firm. While we remain focused on the core services of tax, accounting and audit, we expand and offer you the business consulting needed to remain competitive. We believe the success of our clients is the greatest measure of our own.

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