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Tax Optimized Savings Strategies
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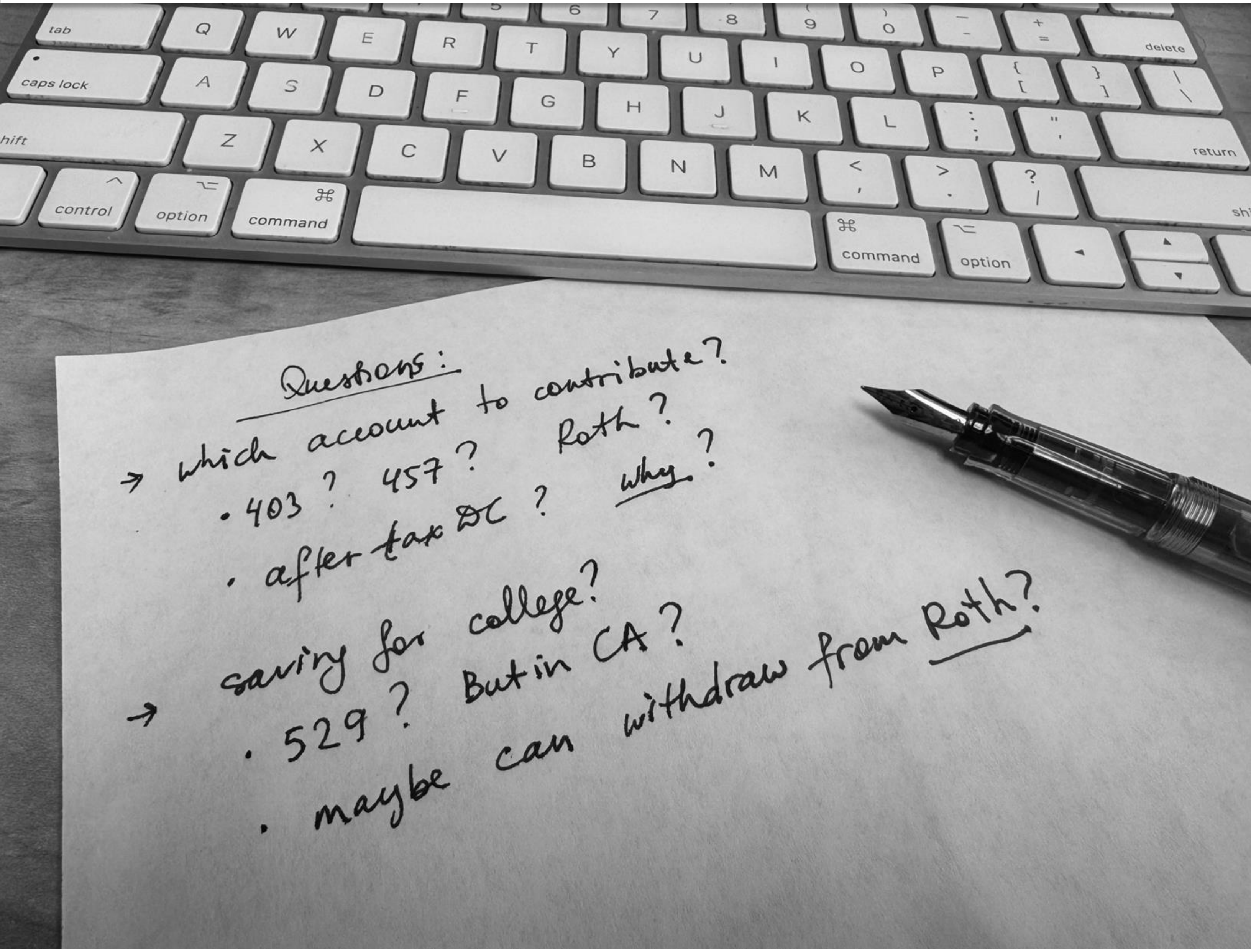

TAX OPTIMIZED SAVINGS

A guide for UC faculty and staff on tax optimal savings strategies

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For questions or comments, please email Prof. Alisa Tazhitdinova: tazhitda@ucsb.edu. Check out our website for other tax literacy resources: pfl.ucsb.edu.

WHY USE TAX-ADVANTAGED ACCOUNTS?

If you save money in a regular savings or brokerage account, any earnings you accumulate are subject to tax – income tax if the account generates income, dividend tax if the account generates dividends, and capital gains tax if the account generates capital gains. The first two tax types are due yearly, as your account receives interest/dividend payments. The latter tax is only due when you sell your investment. Nonetheless, in all cases, your tax liability can be substantial.

Fortunately, you can reduce your tax bill by saving in one of two tax-advantaged savings accounts. The first type, the so-called traditional IRA, allows you to deduct savings from your current tax bill but requires you to pay income taxes on withdrawals in the future. The second type, the so-called Roth IRA, does not allow a tax deduction today but allows for tax-free withdrawals in the future. So, how do these accounts save on taxes? Consider the following example.

Example: Suppose your current income level is $150,000 annually, and your marginal tax bracket is 22%. Suppose you wish to save $12,821 of pre-tax money or $10,000 (= [1-0.22]*12,820) of after-tax money. Your preferred investment strategy is to buy S&P500 index fund shares and keep the money untouched until you retire 20 years later. We will assume that the (nominal) rate of return is 7%.

What should you do?

Option 1. If you invest $10,000 of after-tax funds in a regular brokerage account, then 20 years later your account will have a balance of $38,697. Because the money was invested in a regular brokerage account, when you sell your index fund shares, $28,697 will be subject to long-term capital gains tax, with tax rates between 0% and 23.8% depending on your taxable income. If your tax rate is 15%, your after-tax balance is $34,393.

Option 2. If you invest $10,000 of after-tax money in a Roth IRA account instead, the entire $38,697 will be tax-free. Resulting in savings of $4,304!

Option 3. Alternatively, you could invest in a traditional IRA. Because contributions to traditional IRAs are tax deductible, you will invest pre-tax money -- $12,821. In this case, 20 years later your balance will be $49,609. When you withdraw this money, you will have to pay income taxes. If your marginal tax rate is 22%, your after-tax balance is $38,697, the same as if you invested in a Roth IRA. However, if your marginal tax rate is lower than 22%, your after-tax balance will be higher. And if your marginal tax rate is higher than 22%, your after-tax balance will be lower.

Bottom line: traditional and Roth IRAs allow you to save on taxes. Traditional IRAs lead to higher tax savings if your present tax rate is higher than your future tax rate. The Roth IRA leads to higher savings if your future tax rate is higher than your present tax rate.

RETIREMENT PLANS OVERVIEW

In this section, we review the various tax-advantaged plans available to UC faculty and staff.

If you are aware of the differences between traditional and Roth plans, feel free to skip this section and just review Table 1. Please also take note of the following lesser known features:

(i) Withdrawals from Roth 403(b) plans are generally not allowed and almost always subject to some income taxes and 10% penalty; in contrast, principal withdrawals from personal Roth IRAs are tax and penalty free. (ii) Withdrawals from UC's 457(b) plan are not possible if you are still employed by UC and under age 70.5. (iii) Even if you do not wish to save for retirement, using the Backdoor and Mega-Backdoor Roth can be tax-advantaged for medium-run savings goals, for example, as a more flexible alternative to 529 plans. (iv) Roth and regular 403(b) contributions, Roth and regular 457(b) contributions, as well as regular and after-tax UC DCP contributions are tracked separately by Fidelity, even though UC employees are not able to see different "buckets" in their Fidelity accounts.

For all accounts, contributions are always limited to one's earned income or the limit listed, whichever is lower. For brevity, we only report the maximum limit.

If you are age 50 or older, most plans offer special catch-up provisions, allowing higher contribution amounts. Please review relevant IRS rules, we again omit them for brevity.

Every taxpayer has access to the following two plans:

Traditional IRAs

You can open as many IRA accounts as you wish, with any financial institution. Contributions to these accounts are tax-deductible as long as (i) you are not covered by an employer plan and (ii) your income is not too high. Consequently, for UC employees, for tax year 2025, contributions to these accounts are tax deductible if their income is below $79,000 (single) or $126,000 (married). If your income is above this level, you will qualify for either a partial deduction or your contributions will not be tax deductible. If your income exceeds these cutoffs, make sure to read **After-Tax IRA and Backdoor Roth** below.

For tax year 2025, the maximum contribution amount (to all IRA plans, incl. Roth) is $7,000. Withdrawals from this account must be included in taxable income and are taxed at regular income tax rates. Importantly, if you withdraw any money before turning 59.5, you will be subject to a 10% penalty.

Roth IRAs

You can open as many Roth IRA accounts as you wish, with any other financial institution. Contributions to these accounts are not tax-deductible. However, all withdrawals are tax-free once you turn 59.5 (and had the account for 5+ years)! The maximum contribution amount is $7,000 as long as your income does not exceed $150,000(single) or $236,000(joint),

(Sub)-Plan type	Mandatory employer Contributions	Mandatory employee Contributions	Employee Contribution Limit	Combined Contribution Limit	Tax Deductible?	Withdrawals after age 59.5 taxable?	Early (age<59.5) withdrawal penalty?	Mandatory distributions age 73+?
UC DCP 401(a) plan	0-8% depending on the plan	0-7.5% depending on the plan	n/a	$70,000 applies to mandatory employee +mandatory employer +after-tax contributions	yes	yes	yes	yes
UC DCP After-tax / Mega Backdoor Roth	n/a	n/a	n/a		no	not once rolled over to Roth	not for principal after 5 years	not once rolled over to Roth
403(b)	3.5% of summer salary only	3.5% of summer salary only	$23,500 (summer contributions excluded) applies to 403(b) +Roth 403(b) +401(k) +Roth 401(k) + Solo 401(k)	non-binding because UC does not contribute	yes	yes	yes	yes
Roth 403(b)	n/a	n/a			no	no	yes	no
Non-UC 401(k)	varies	varies		$70,000 per employer/plan	yes	yes	yes	yes
Non-UC Roth 401(k)	varies	varies		$70,000 per employer/plan	no	no	yes	no
Solo 401(k)	n/a	n/a		$70,000 per employer/plan	yes	yes	yes	yes
457(b)	n/a	n/a	$23,500 applies to 457(b) +Roth 457(b)	non-binding because UC does not contribute	yes	yes	no, but withdrawals not allowed until age 70.5 or while employed with UC	yes
Roth 457(b)	n/a	n/a			no	no	no, but withdrawals not allowed until age 70.5 or while employed with UC	no
IRA	n/a	n/a	$7,000 applies to IRA (pre or after-tax) +Roth IRA	n/a	yes	yes	yes	yes
Backdoor Roth	n/a	n/a		n/a	no	not once rolled over to Roth	not for principal after 5 years	no
Roth IRA	n/a	n/a		n/a	no	no	not for principal	no
SEP IRA	n/a	n/a	25% net earnings	n/a	yes	yes	yes	yes
SIMPLE IRA	n/a	n/a	$16,500	n/a	yes	yes	yes	yes

Notes: contributions are always limited to one's earned income or the limit listed, whichever is lower. All limits apply to tax year 2025. Qualified Roth withdrawals are tax free once the account has been open and funded for 5 years. For detailed withdrawal rules see Withdrawals and Mandatory Withdrawals.

and applies to the sum of your contributions to all traditional IRAs and Roth IRAs. If your income exceeds theses cutoffs, you are not allowed to *directly* contribute to your Roth IRA, but make sure to read **After-Tax IRA and Backdoor Roth** below for a perfectly legal work-around.

If you made contributions directly to your Roth account, withdrawals of the principal can be made at any time and are always tax-free. If your contributions came via conversion or rollover (backdoor or mega-backdoor, for example), there is a 5-year waiting period during which withdrawals of principal may incur a 10% penalty. However, if you withdraw earnings on principal before turning 59.5, you will be subject to a 10% penalty.

Both Traditional IRAs and Roth IRAs allow for penalty-free qualified withdrawals. Please review the Withdrawals section for details.

Once you turn age 73, you are required to withdraw funds from your IRA but not from your Roth account. Please review the Mandatory Withdrawals section for details.

After-Tax IRA and Backdoor Roth

If your income is too high to directly contribute to a Roth IRA, or if your income is too high to make your IRA contributions tax-deductible, you can take advantage of the so-called Backdoor Roth strategy. All you have to do is make contributions to the IRA account and then transfer to your Roth account. This is 100% legal. Once in the Roth account, withdrawals of *principal* will be tax-free (at most) 5 years after the rollover. Withdrawals of earnings are subject to the usual rules.

What are the immediate tax implications of this procedure? Several cases are possible. (1) If all the money in all of your IRA account(s) are after-tax contributions, then you will face no tax liability at all because your IRA contributions have already been subject to income taxes. (2) If the situation is as above, but your contributions grew in value prior to the rollover, then you will have to pay income tax on the *earnings* but not on the contributions themselves. Consequently, it is best to roll over after-tax IRA contributions first, then invest your contributions. Furthermore, you will be able to withdraw your after-tax contributions tax and penalty-free, but withdrawals of converted earnings will be subject to a 10% penalty if withdrawn within 5 years of the rollover. See the Withdrawals section for details. (3) If you have some after-tax and some pre-tax contributions in your IRA account(s), then you will have to pay income taxes, even if you only roll over after-tax contributions, because of pro-rata rules. Basically, the pro-rata rules assume that you are converting a *share* of your overall IRA portfolio rather than a specific (after-tax) portion. Consequently, income tax is due on the portion of the pre-tax contributions that are being converted. Unfortunately, the pro-rata rule applies to your combined IRA balance, not to each IRA account individually.

The bottom line: if you use the backdoor strategy, it is best to transfer after-tax contributions shortly after depositing them, and to not have any pre-tax contributions in your IRA account(s) to avoid pro-rata rules. This can be achieved by rolling your pre-tax IRA money into your 403(b) or 401(k) account(s).

In addition to the primary retirement 401(a) plan(s) (UCRP or Safe Harbor) not discussed here, UC employees have access to the following plans:

403(b) Plan

Contributions to 403(b) plans are tax-deductible and withdrawals are taxed at regular income tax rates, with an additional 10% penalty for withdrawals prior to turning 59.5. Thus, from a tax perspective, a 403(b) plan is equivalent to a traditional IRA.

Contributions are governed by one limit: the "employee contribution limit" which is $23,500 for tax year 2025. This limit applies to the sum of employee contributions to any 401(k) and 403(b) plan an individual is a member of. Consequently, if you contribute to a 401(k) plan with a different employer or to a self-employment plan, make sure not to exceed this limit.[1]

Roth 403(b) Plans

UC offers the option of making post-tax contributions to the 403(b) plan. Note that when you log in to Fidelity, you will only see one 403(b) account. However, when making contribution elections, you can designate your contributions as pre-tax or Roth. If you do the former, the above rules apply. However, if you choose the latter, your contributions will not be tax-deductible, but your withdrawals will be tax-free. Thus, from a tax perspective, the Roth 403(b) plan is equivalent to a Roth IRA. Unfortunately, in contrast to the personal Roth account, withdrawals of principal prior to age 59.5 are generally not allowed and typically incur income taxes and a 10% penalty. See Withdrawals section for details.

The "employee contribution limit" that applies to the sum of 403(b) and 401(k) contributions, also applies to the Roth 403(b) contributions.

457(b) Plans

Contributions to 457(b) plans are tax-deductible and withdrawals are taxed at a regular income tax rate (thus tax-wise equivalent to a traditional IRA). Contributions are governed by one limit that is independent of the employee contribution limit that applies to 403(b) and 401(k) plans. The limit applies to the sum of the employee and employer contributions (though UC never contributes), and for the tax year 2025 is $23,500.

A key difference with a 403(b) plan is that while withdrawals are not subject to the 10% penalty, they are not allowed until the individual leaves UC or turns age 70.5.

Roth 457(b) Plans

UC offers an option of making post-tax contributions to the 457(b) plan. Practically, when you log into Fidelity, you will only see one 457(b) account. However, when making contributions you can designate these as pre-tax or Roth. If you do the former, the rules above apply. If you choose the latter, your contributions will not be tax-deductible, but your withdrawals will be tax-free, similar to a

[1] Technically speaking, a separate limit applies to the sum of employee and employer contributions, but given that UC does not make contributions to this plan except for summer salaries, this second limit is non-binding.

Roth account. The $23,500 limit applies to the sum of 457(b) pre-tax and 457(b) Roth contributions. Once again, withdrawals are not allowed while you are employed by UC.

After-Tax UC DCP and Mega Backdoor Roth

Whether or not you elected or were defaulted into a UCRP or UC DCP plan, you can make voluntary after-tax contributions to the UC DCP plan. Note that these contributions are not tax deductible and if they remain in the UC DCP account, withdrawals of earnings are subject to income taxes. So why should you make after-tax contributions to the UC DCP plan? Because these contributions can be rolled over into a Roth IRA. Once rolled over, the principal can be withdrawn tax-free (at most) 5 years after the rollover, while earnings can continue to grow and be withdrawn tax-free once you turn 59.5. Withdrawals of earnings prior to turning age 59.5 are subject to a 10% penalty and income taxes. For this reason, this approach is referred to as "Mega Backdoor Roth".

Why mega? For tax year 2025, the limit for after-tax contributions is $70,000 but it applies to the sum of voluntary after-tax contributions plus mandatory UC DCP contributions (both employee and employer) or Safe Harbor contributions. Consequently, if you only contribute to the UCRP, then the entire $70,000 limit is available to you since no other contributions count towards the limit. If you elected UC DCP, if you are in the hybrid UCRP + UC DCP top-up plan, or if you are in the Safe Harbor plan, then the available contribution space is reduced by the sum of your and UCSB contributions. Because Fidelity tracks pre-tax and post-tax contributions separately, conversions from UC DCP after-tax sub-account to your Roth account will not suffer from pro-rata rules. Therefore, you will not face tax liability when rolling over your after-tax contributions even if your account has some pre-tax contributions, as long these after-tax contributions have not generated earnings.

The bottom line: if you use the mega backdoor strategy, it is best to transfer after-tax contributions into your Roth account shortly after depositing them into UC DCP.

Contributions to 403/457/UCDCP plans can only be made via payroll deductions, which take one to two months to take effect. Plan accordingly – retroactive contributions are not allowed!

Once you turn age 73, you are required to withdraw funds from your 403(b) and 457(b) but not from your Roth 403(b) and Roth 457(b) accounts. See Mandatory Withdrawals.

If you have self-employment income or are employed elsewhere, you may have access to the following plans:

401(k) Plans and Roth 401(k)

These accounts are offered by other employers, UC does not offer a 401(k) plan. Contributions to 401(k) plans are tax-deductible and withdrawals are taxed at regular income tax rate, plus a 10% penalty for withdrawals that occur prior to turning 59.5. Thus, tax-wise 401(k) plans are equivalent to traditional IRAs and 403(b) plans. Contributions to Roth 401(k) plans are not tax deductible but withdrawals are tax-free. Thus, from a tax perspective, the Roth 401(k) plan is equivalent to a Roth IRA.

Contributions are governed by two limits. First, by the "employee contribution limit" which is $23,500, and which applies to the sum of employee contributions to any 401(k), Roth 401(k), 403(b), and Roth 403(b) plans an individual is a member of. Thus, the sum of your contributions to the UC 403(b) plan (Roth and pre-tax) and this plan are subject to the $23,500 limit. Second, by a combined employer/employee limit which applies to all contributions made to the plan in a given year. This limit is $70,000. However, because this limit is *per employer*, it is not affected by your and UC's contributions to UC plans.

Solo 401(k), SEP-IRA, SIMPLE IRA

If you have self-employment income (e.g. from speech honorariums, consulting, etc.), you can open a Solo 401(k), SEP-IRA, or a SIMPLE plan with any financial institution. Most financial institutions offer such plans free of charge, and the paperwork is minimal.

The three plans vary slightly in their complexity and contribution limits. The most generous limit is available with a Solo 401(k) plan: you can make contributions as an employee (in which case the $23,500 limit discussed above applies) as well as an employer. As an employer, you can contribute up to 25% of your net self-employment earnings not including contributions for yourself. (The definition and the math are a bit complicated, so use online tools to estimate your limit.) SEP IRAs allow you to make employer contributions (25% of net earnings) like the Solo 401(k). Finally, the SIMPLE IRA Plan contribution limit is the lowest at $16,500 of employer contributions for the 2025 tax year.

It is important to note that if you max out your UC 403(b) account, the employee contribution limit of the Solo 401(k) plan becomes unavailable to you. Consequently, Solo 401(k) and SEP IRA become equivalent.

If you have children, you can also open:

Custodial Roth accounts

If your child earns some income (e.g. wages from summer jobs or self-employment income from babysitting), they could get a head start on savings by contributing to a Custodial Roth account. Put simply, these are Roth IRAs opened in the name of a minor with parent(s) acting as a custodian. Once the child turns 18 or 21, the assets must be transferred to a new account in their name. The contributions are limited to the child's earned income or the usual Roth limit ($7,000) whichever is lower. Note that while self-employment income (babysitting, gig work, etc.) counts towards the limit, once self-employment earnings exceed $400, a 15.3% self-employment tax is due.

A custodial Roth account can serve several purposes. First, it can be used to teach children financial literacy. Second, these accounts can be attractive to parents who, otherwise, maxed out their tax-advantaged contributions. The child can later use Roth funds (ideally, principal only) to fund their college attendance. Third, these accounts are an attractive savings option for parents who plan to leave a bequest to their children and do not mind giving up control of such bequest early on.

⚠ Remember, you seize control of these contributions since they are made in your child's name and the child will have full control over the money once they turn 18.

TAX-OPTIMAL SAVINGS STRATEGIES

The optimal savings strategy depends on your savings goals and/or your income trajectories:

1. If you do not necessarily wish to save for retirement but have extra cash and would like to tax-optimize your savings (e.g. college funds for kids, renovations, etc.), use the Roth, backdoor Roth, or mega-backdoor Roth accounts.
2. If you want to save for retirement and you expect your income in retirement to be *lower* than your present income level, then you should use the IRA, 403(b), or 457(b) as your savings accounts.
3. If you want to save for retirement, and you expect your income in retirement to be *higher* than your present income level, then you should use the Roth IRA (direct or backdoor), mega-backdoor Roth, or Roth 403(b) and Roth 457(b) as your savings accounts.
4. If you are not sure about your income trajectories but want to save for retirement, consider a mix of pre-tax and Roth accounts.

⚠ No matter how you choose to save your money, make sure to invest your contributions! UC offers many choices but economics/finance research shows that market indices (S&P 500, DJIA) tend to outperform mutual funds and even hedge funds in the long run! Consequently, broad market index/mutual funds are the most efficient investment tools: they offer the best rates of return in the long run, require zero involvement from you, and feature the lowest management fees.

We now explain the tax justification behind each approach.

1. Medium-run savings using Roth, Backdoor Roth or Mega-backdoor Roth

The advantage of Roth accounts is that you can withdraw the principal at any time without penalty (if the funds were directly contributed to the account or represent pure after-tax rollovers) and after 5 years (if the funds rolled over into the Roth account included earnings or pre-tax conversions). Practically, this means that if you deposit any spare savings into this account, in at most 5 years, you can withdraw your contributions tax-free and leave any accumulated earnings to continue growing tax-free in your account. If, instead, you saved this money in a taxable account, your earnings would be taxable, either at the income tax, dividend tax, or at the capital gains tax rate, depending on the nature of your investments. For a typical employee, this is equivalent to a 15-20% tax break! Thus, if you optimally perform the backdoor strategies (convert after-tax contributions immediately), you are saving 15-20% on future tax liability, with complete freedom to spend your money (principal only) however and whenever you want. See more detailed discussions in sections Saving for College or First Home Purchase. And make sure to review Early Withdrawals section for exact rules.

2. Retirement savings using IRA, 403(b), 457(b) accounts

IRAs and 401(k)/403(b)/457(b) accounts are tax-efficient for people with a high tax liability at the moment and lower expected tax liability in the future. You should use these accounts when you are at your "employment peak," in a sense that you do not think you will earn as high of a salary in the future, and if you think you will not have as high of income once you retire (measured as the sum of employer pensions, Social Security, and flows from retirement accounts). For example, if your current earnings are $150,000 per year but during retirement you expect your UCRP pension to be $50,000 and your Social Security pension to be $20,000. Then, you should contribute to an IRA/403(b)/457(b) account. Most likely, the withdrawals you make from these accounts during retirement would not bring you above the $150,000 earnings level.

Tax-deductible contributions also allow you to lower your income tax bracket in years when your income is unusually high (e.g. because of an unusually high summer salary or extra self-employment income in that year only). For example, if your (joint) taxable income is $120,000 in 2024, your income above $94,300 will be subject to the 22% tax rate. If you contribute $25,700 to some combination of IRA/403(b)/457(b) accounts, you will avoid the 22% tax bracket altogether!

IRA/403(b)/457(b) accounts are largely equivalent, so feel free to contribute to whichever one you'd like. However, if you want to have access to a hassle-free Roth backdoor conversion, having zero pre-tax contributions in your IRAs is ideal. For this reason, it may be optimal to save primarily in a 403(b) account as these contributions would not affect Roth conversions. Having said that, you always have access to the UC DCP mega-backdoor Roth rollover option, which does not suffer from pro-rata rules. 457(b) withdrawals are limited during your employment with UC, so this account offers lower flexibility if you plan on staying with UC for a long time, but not otherwise.

3. Retirement savings using Roth, backdoor Roth, mega-backdoor Roth, and Roth 403(b)/457(b) accounts

Roth accounts are tax-efficient for people with a low tax liability now and a higher expected tax liability in the future. These accounts should be used by individuals who expect to earn a higher income in retirement than they do now. If you are (or plan to be) a long-term UC employee and you are enrolled in a UCRP plan, you are likely to fall into this category, since UCRP offers high pension replacement rates for faculty and staff with long service years. For example, if you retire once you reach 65 (or later) and have 40 years of service, your pension is 100% of your average earnings during the 36 months preceding retirement. (Review UCRP rules for exact definitions and benefit rules). On top of that, you will receive a Social Security pension. Consequently, if you work at UC for a long time, your total pension is likely to be similar to or even higher than your current salary. In this case, any withdrawals from an IRA/403(b)/457(b) may lead to a higher taxable income in retirement than during your career.

In this case, you are better off contributing to a Roth account: directly, via backdoor rollover or via mega-backdoor Roth rollover, or using Roth 403(b)/457(b) accounts. The former, while more tedious, is a slightly better option because withdrawals of principal are always tax and penalty-free, giving you more flexibility in case of unexpected life shocks.

One final advantage of Roth accounts is that they provide the highest level of clarity about one's retirement income. Whatever you have in your account when you retire is what you can spend, there will be no further taxes to worry about. In contrast, your IRA/403(b)/457(b) earnings will be subject to prevailing tax rates, whatever these may be in the future.

4. Mixed strategy

If you are not sure about your retirement income, consider a mixed strategy – contribute to both pre-tax and after-tax accounts. This approach will give you additional flexibility in optimizing your retirement withdrawals. By withdrawing some taxable and some tax-free income, you will be able to simultaneously target the income level and the tax bracket.

SAVING FOR COLLEGE

First, you could use a **Roth account**. The **key advantage** of this approach is that the money is **not tied to college attendance** and can be used for anything you like, in case you change your mind.

The **key disadvantage** is that you can only withdraw earnings if you are 59.5 or older. Consequently, if your child attends college before you turn 59.5, then you must have enough principal (i.e. contributions) in your account or you will have to pay taxes on early withdrawals, negating the Roth tax advantage. (Note: you are allowed to make withdrawals of *earnings* from your Roth IRA for qualified education expenses without the 10% penalty. However, earnings withdrawals will be subject to income taxes, which negates the main tax advantage of the Roth account.)

The bottom line: Roth is the preferred approach if your savings are large enough to finance the cost of college attendance through contributions alone (while leaving earnings in the account until you turn 59.5). Make sure to review **the <u>Early Withdrawals</u>** section to understand the early withdrawal rules.

If you plan to use Roth accounts, use <u>UC DCP Backdoor Roth</u> approach to make contributions, make sure to transfer your after-tax contributions shortly after making them. In this case, withdrawals of principal will be tax and penalty free.

Second, you could use a **<u>529 plan</u>**. From a tax perspective, these plans operate similarly to a Roth account: contributions are not tax deductible, but withdrawals for **qualified education expenses only** are tax-free. In some states, contributions are deductible from state income taxes, but not in California. A wide range of educational expenses qualify: tuition, fees, room and board for accredited colleges, universities (both undergraduate and graduate programs), and even primary/secondary school tuition (up to $10,000). A separate account must be opened for each child; however, it is costless and straightforward to transfer funds between 529 accounts.

The **key disadvantage** of the 529(b) plan is that once the funds are in the account, you can **only use these funds for qualified education purposes** or you will lose the tax advantage and incur a penalty. Thus, if your child decides not to attend college, and you do not have other children or grandchildren to transfer the funds to, and you and your spouse do not wish to further your own education, earnings withdrawals will be subject to federal and state income taxes plus a 10% federal tax penalty plus a 2.5% California tax penalty. While income taxes are always due on non-qualified earnings withdrawals, the penalty will not apply if withdrawals are due to the beneficiary's death, permanent disability, or attendance at a military academy. If the 529 account has been opened for over 15 years, it is possible to roll up to $35,000 into a Roth account, but the rules are rather restrictive.

The bottom line: The 529 plan is a good approach if you have many potential beneficiaries, you are very confident about (at least some of) your beneficiaries attending college, and you cannot finance college with contributions alone (you must rely on earnings, too).

Finally, you are allowed to make withdrawals from your IRA account for qualified education expenses, but not from your 403(b)/401(k)/etc. plans. The withdrawal from the IRA will be subject to income tax but not the 10% penalty, while withdrawals from 403(b)/401(k)/etc will be subject to both income tax and 10% penalty.

SAVING FOR A HOME PURCHASE

There are no designated tax-advantaged schemes to save for a home purchase. Consequently, the only tax-advantaged approach is to use a Roth account. Recall, that you can always withdraw your principal tax-free. If the principal was contributed directly to the account or if you used rollovers of after-tax contributions (with no accumulated earnings), then there would be no waiting period. Otherwise, rollover funds can be withdrawn after 5 years, tax and penalty-free. Your earnings will continue to grow tax-free. Review the Early Withdrawals section for exact rules.

If you need to withdraw earnings, the tax code allows first-time home buyers to withdraw $10,000 *penalty-free and tax-free* if their Roth account has been opened for 5 years or longer. Otherwise, an earnings withdrawal (up to $10,000) will be penalty-free but subject to income tax. Withdrawals of up to $10,000 from IRA accounts will also be penalty-free but subject to income tax.

While withdrawals from 403(b)/457(b) plans are not allowed if you are still employed by UC, you could claim a hardship withdrawal for the purchase of a primary residence. However, such withdrawals will be subject to income taxes and the 10% penalty (no home purchase exemptions available for 403(b)/457(b)/etc. plans).

Instead of a withdrawal, you could take a loan from your 401(k), 403(b) or 457(b) account. Such loans are allowed by UC plans. As long as you fulfill loan obligations, there will be no penalties, but you will be required to pay interest to yourself and a small administrative fee. These interest payments are not tax-deductible so the whole strategy is not tax-optimal. Furthermore, taking such a loan may adversely affect your mortgage eligibility.

Once you purchase your first home, make sure to claim the First Time Home Buyers credit: a refundable credit equal to 10% of the purchase price up to $8,000. The credit can only be claimed by resident aliens, who purchased a primary residence inside the U.S. for less than $800,000 and earn less than $125,000 (single) or less than $225,000 (married). If you earn higher amounts, the credit is phased out.

Make sure to also claim the Home Mortgage Interest Deduction. This deduction allows you to deduct interest expenses (including points) associated with the first $750,000 of your mortgage loan.

EARLY WITHDRAWAL RULES

Once you turn 59.5, withdrawals are (generally) no longer subject to the 10% rules. What happens if you need to withdraw funds prior to turning 59.5?

Withdrawals from IRAs and 403(b)/457(b)

The withdrawal rules for IRAs are simple, because any withdrawal amount is taxable. The only uncertainty is whether a pre-age-59.5 withdrawal is subject to the 10% penalty or not. The penalty applies to the full withdrawal amount and is calculated in Part I of Form 5329. The following withdrawals are exempt: to pay for qualified higher education expenses, first-time home purchase (up to $10,000), large medical expenses (greater than 7.5% of AGI), birth or adoption, other special circumstances, or because of disaster, disability, or death.

Early withdrawals from 403(b)/401(k) plans are generally not allowed if you are still employed by the sponsoring employer. As a workaround, you could either rollover the funds to an IRA account and then withdraw, or you could claim a special circumstances hardship withdrawal. Such withdrawals will be subject to income taxes, and the 10% penalty unless they qualify for the exemption. Note that exemption rules for IRA and 403(b)/457(b) are different, the latter are more stringent.

Withdrawals from Roth 403(b)/457(b)

While withdrawals from Roth 403(b)/457(b) plans are generally not allowed if you are still employed by the sponsoring employer, you could claim a hardship withdrawal in special circumstances. The taxation of such withdrawals is subject to two rules.

First, if your account contains both after-tax contributions and earnings, then the taxable amount will be determined by multiplying the withdrawal amount by the ratio of earnings to the total balance. In other words, the IRS assumes that you withdraw contributions and earnings in respective proportions. Importantly, you will be subject to this pro-rata rule even after you turn 59.5 if the first contribution was made less than 5 years ago to the Roth 403(b)/457(b) plan.

Second, the taxable portion of the withdrawal will also be subject to the 10% penalty if it was made before age 59.5, and it does not qualify for an exemption.

Example: Suppose you have $20,000 of after-tax contributions and $5,000 earnings in your Roth 403(b). If you withdraw $21,000 prior to turning 59.5, then $4,200 will be subject to income tax because earnings account for 20% of your portfolio. Consequently, 20% of your withdrawal will be treated as earnings rather than principal. If the withdrawal was done for a qualified need (e.g. to pay for very large medical expenses) then no 10% penalty will be due. Otherwise, you will be required to pay a 10% surtax on top of income tax on $4,200.

Bottom line: early withdrawals from IRAs, 403(b), 401(k), 457(b) and Roth 403(b), 401(k), and 457(b) generally lead to a tax bill and a 10% penalty, and, for this reason, are best avoided. In contrast, Roth IRAs offer more flexibility and should be used instead.

Withdrawals from Roth IRAs

If your Roth account consists of direct contributions, immediate rollovers of after-tax IRA and/or UC DCP contributions (i.e. rollovers that did not generate tax liability in the year of rollover), and earnings on the above, then withdrawals of principal will always be tax- and penalty-free.

Otherwise, the rules governing withdrawals from Roth IRAs, while intuitively simple, are complex. In this section, we explain the rules and provide illustrating examples.

First, **no taxes or penalties** are due if the whole distribution is considered a **"qualifying distribution"**. The following conditions must be satisfied: (1) the Roth account has been opened for 5 years and (2a) withdrawal was made after you turn 59.5, or (2b) withdrawal was made for a first home purchase (up to $10,000), or (2c) you are disabled or deceased.

Second, if the distribution **is nonqualified**, then you will have to **pay taxes** on the portion of the distribution attributed to **earnings**. The IRS has a strict ordering rule for distributions: from the amount of nonqualified distributions, you first subtract direct contributions, then conversions and rollover contributions on a first-in-first-out basis, then earnings. Therefore, if you have enough direct contributions, conversions, and rollovers to cover your withdrawal, no income tax will be due. The taxable portion is calculated in Part III of Form 8606.

In addition, if the distribution is **not taken** to pay for qualified higher education expenses, first-time home purchase (up to $10,000), large medical expenses (greater than 7.5% of AGI), birth or adoption, other special circumstances, or because of disaster, disability, or death, then a **10% penalty** is due on: (a) **earnings**, and (b) **recapture amounts**, i.e. the portion of distribution attributed to the **taxable share** of IRAs/403(b)s/etc. conversions or rollovers completed within **the past 5 years**. Therefore, if parts of the funds you withdraw come from a recent (<5 years) rollover on which you had to pay income taxes, you will be subject to recapture rules.

⚠ **This is why it is recommended to rollover your after-tax IRA/after-tax UC DCP contributions into your Roth plan as soon as possible.** The penalty is calculated in Part I of Form 5329. Note that Form 5329 instructions are much easier to follow than Publication 590-B.

Example 1: Suppose your Roth account is "composed" of $10,000 of direct contributions, $20,000 of rollovers from the UCDCP after-tax account, and $5000 of earnings. Say, you need to withdraw $9000 for personal needs. Answer: Since your direct contributions exceed $9000, no tax and no penalty are due, you will simply have to fill out Form 8606 Part III when filing your tax return.

Example 2. Same balances as above but you need to withdraw $31,000 to pay for a first-time home purchase. The $20,000 rollover was completed 7 years ago. Answer: The first $10,000 of your withdrawal is qualified since the account has been opened for 5 years or longer. The remaining $21,000 is nonqualified. From $21,000 subtract $10,000 of direct contributions and the $20,000 rollover basis. Thus, your taxable amount is zero. However, because your direct contributions ($10,000) are lower than your nonqualified withdrawal ($21,000), you will be required to fill out Form 5329 to determine the applicable 10% penalty, if any. On line 1 of Form 5329, you will have to include the following: (a) the amount from line 25c of Form 8606 (i.e. taxable portion of the distribution, in your case $0), (b) the $10,000 qualified home-purchase withdrawal, (c) recapture amount from rollovers completed in the previous 5 years -- $0 (your rollover is 7 years old!). The home purchase qualifies for an exemption of $10,000 -- include on line 2 of Form 5329 with exemption code 9. No income tax and no 10% penalty are due.

Example 3. Same balances and withdrawal amount ($31,000 to pay for a first-time home purchase) as Example 2 but the $20,000 rollover was completed 3 years ago when you first opened your Roth account. Answer: The first $10,000 of your withdrawal is not qualified because the account had not been funded for 5 years or longer. Consequently, the entire $31,000 withdrawal is considered nonqualified. From $31,000, subtract $10,000 of your direct contributions and the $20,000 rollover basis. Your taxable amount is $1,000. Because your direct contributions ($10,000) are lower than your nonqualified withdrawal ($31,000), you are required to fill out Form 5329 to determine the applicable 10% penalty, if any. On line 1 of Form 5329, you will have to include the following: (a) the amount from line 25c of Form 8606 (i.e. taxable portion of the distribution, in your case $1,000), (b) qualified home purchase withdrawals ($0), (c) the recapture amount from rollovers completed in the previous 5 years, an amount between $0 and $20,000. Note that this recapture amount will be equal to the *taxable* amount of your rollovers (listed in line 18 of Form 8606 and line 5b of Form 1040). This will depend on whether the rollover consisted entirely of after-tax contributions (then recapture is $0) or of some after-tax contributions and earnings (because you did not rollover immediately). The earnings portion will be taxable in the year of the rollover and subject to recapture rules! If you did not have to pay any income tax *because of the rollover in the year you performed the rollover,* then the recapture amount is $0. Alternatively, if the rollover represented a conversion from a traditional IRA to a Roth, then the entire amount of conversion will be taxable in the year of rollover and will be part of the recapture amount. However, only rollovers/conversions completed in the last 5 years are subject to recapture rules! The home purchase qualifies for an exemption of $10,000 (included on line 2 of Form 5329 with exemption code 9). Consequently, between $1,000 to $11,000 will be subject to the 10% early penalty.

Example 4. Same balances as Example 1 but you need to withdraw $31,000 to pay for your child's college tuition. Solution: The entire withdrawal is nonqualified. The taxable amount is $1,000 (see explanation for Example 3). When filling out Form 5329, you will include the following on line 1: (a) the taxable portion of the distribution, in your case $1,000, (b) the recapture amount ($0-$20,000, see Example 3 explanations), (c) qualified home purchase withdrawal ($0). On line 2 of Form 5329, you include $31,000 with exemption code 8, none of the withdrawals is subject to the 10% penalty

MANDATORY WITHDRAWALS AND ESTATE RULES

Required Minimum Distributions

Once you turn 73, you must start taking minimum withdrawals from your IRA, SIMPLE IRA, and SEP IRA plans. The minimum withdrawal amount depends on your balance, age, and marital status. The same rules apply to 401(k), 403(b), and 457(b) plans, except that you are not required to make minimum withdrawals **while you are still employed by the plan sponsor** unless you are a 5%+ owner of the business. Once you retire or turn 73, whichever comes later, you must make mandatory withdrawals.

In contrast, withdrawals from Roth IRAs, Roth 401(k), Roth 403(b), and Roth 457(b) accounts are not required until the death of account owner. However, beneficiaries of the Roth IRAs, Roth 401(k), Roth 403(b), and Roth 457(b) are subject to the required minimum distribution rules (described next).

Estate Rules

What happens to the money left in your tax-advantaged plans when you die? A surviving spouse can roll over the IRA/403(b)/401(k)/457(b) funds into their own IRA/etc. account. If they do so, then they will be subject to the required minimum distributions based on their life expectancy. Alternatively, a surviving spouse can keep it as an inherited account and take distributions based on his/her life expectancy, or delay distributions until the deceased spouse would have turned 72.

If the account beneficiary is not a surviving spouse but a minor child, disabled, chronically ill, or an individual who is not more than 10 years younger than the account holder, then the beneficiary may take distributions over the longer of their life expectancy and the deceased's remaining life expectancy. In all other cases, beneficiaries must follow the 10-year rule: empty the account by the end of the 10th year following the account owner's death.

Note that in all cases, withdrawals from IRA/403(b)/457(b)/401(k) plans must be included in the beneficiary's taxable income and hence subject to income taxes. If the surviving spouse is younger than age 59.5, she/he can withdraw the funds without incurring the 10% penalty (but still subject to income taxes).

Roth IRA rules are essentially the same (beneficiaries are subject to mandatory withdrawals), however, withdrawals are tax-free as long as the deceased's Roth account was open for 5 years or longer.

Which account to bequeath?

From the beneficiaries' perspective, Roth accounts are always better because the inheritance is (usually) tax-free. (Effectively, the deceased "pre-pays" income taxes on the beneficiary's behalf). However, from a tax perspective, you should bequeath your IRA/403(b)/etc. funds if your tax bracket is higher than your child's (**at the expected time of withdrawal!**), and you should bequeath your Roth IRA/Roth 403(b) if your tax bracket is lower than your child's.

TAX FORMS AND PRACTICALITIES

IRA and Roth contributions

You can make IRA/Roth contributions directly from your bank to an IRA/Roth account. You have until April 15, 2026, to make contributions for tax year 2025. Remember, you are only eligible to make direct Roth contributions if your taxable income does not exceed $150,000 (single) or $236,000 (joint).

If you make IRA/Roth contributions, you will receive Form 5498 listing the amount of contribution made. Make sure to enter this information when filing a tax return even if your contributions represent after-tax contributions, so that your tax software tracks these using Form 8606.

Backdoor Roth and Mega-Backdoor Roth

Backdoor Roth: you can rollover funds from an IRA to a Roth account online if both accounts are in the same financial institution. In Fidelity, this is called a "transfer", and it takes 1 business day to show up in your Roth account. You can make similar transfers across financial institutions, but these will take longer.

Mega Backdoor Roth: once you made after-tax contributions to UC DCP plan via payroll deduction, call Fidelity (1-800-248-4213) to rollover funds from your UC DCP after-tax sub-account to a Roth account. While this was being written, doing so online was not possible. The funds will appear in your Fidelity Roth account the next business day. Check with Fidelity if you wish to make a rollover to a Roth account at another financial institution.

If you rollover funds from an IRA or UC DCP account to a Roth account, you will receive Form 1099-R (distributions) and Form 5498s (showing Roth rollover contribution) in addition to Form 5498 listing contribution to the IRA account (if such were made). Make sure to add this information when filing your taxes, and be careful when reading tax software prompts. (What you are doing is a rollover, not a conversion or recharacterization.)

UC DCP after-tax, 403(b) and 457(b) pre-tax and Roth contributions

Remember: you cannot transfer money to these accounts directly, instead, you must elect the amount (either in $ or as % of your income) and the nature of the contribution (pre-tax or Roth, if applicable) in fidelity.com or myUCretirement.com. The funds will be withdrawn from your next paycheck and deposited accordingly. Two practical notes: if you make elections shortly before the upcoming paycheck, the election may not take place immediately. The exact cutoff date has been changing, so please review the instructions when making changes. Second, the contributions will not show up in your account on the day of the paycheck, it takes 1 business day to appear in your Fidelity account (for some reason.)