

Essential Activity 8`

Tax-Advantaged Accounts: Which Account Fits?

Name: _____

Part 1: Know Your Accounts

Directions: Review the chart below. Then answer Questions 1–4 using information from the chart. Pay attention to each account’s purpose, tax treatment, and requirements or restrictions.

Account	Primary purpose	Tax advantages	Important considerations
Traditional IRA	Retirement saving	Contributions may be tax-deductible; investment earnings grow tax-deferred. Withdrawals are generally taxed as income.	Individual account; deduction eligibility and contribution limits apply.
Roth IRA	Retirement saving	Contributions use after-tax dollars; qualified withdrawals, including earnings, are tax-free.	Income eligibility, contribution limits, and withdrawal rules apply.
401(k)	Employer-sponsored retirement saving	Traditional contributions are generally pre-tax; Roth contributions are after-tax. Tax treatment of qualified withdrawals depends on contribution type.	Employer matching may be available. Employer contributions may be subject to vesting.
529 plan	Qualified education expenses	Contributions are not federally deductible; earnings and qualified withdrawals are generally federally tax-free.	State tax benefits vary. Nonqualified withdrawals may result in taxes and penalties on earnings.
Health Savings Account (HSA)	Current and future qualified medical expenses	Eligible contributions receive federal tax advantages; earnings grow tax-free; qualified medical withdrawals are tax-free.	Contribution eligibility generally requires qualifying health coverage, including an HSA-eligible high-deductible health plan. Unused funds generally carry forward from year to year.

Remember: An account is not an investment. A Roth IRA, for example, may hold stocks, bonds, mutual funds, or other permitted investments. Its tax treatment does not guarantee a return or protect against investment losses.

1. Which two accounts are specifically designed for individual retirement saving?
2. Which account may offer an employer matching contribution? Explain why an employer match can be valuable.
3. Identify the account designed for qualified education expenses and the account designed for qualified medical expenses.
4. Compare a traditional IRA and a Roth IRA. What is the primary difference in when the investor receives the federal income tax benefit?

Part 2: Which Account Fits?

Directions: For each scenario, identify an account that addresses the stated goal. Explain your selection using at least one feature from the chart. Show your calculation when requested. More than one account may be appropriate in some situations.

Scenario 1: Jordan is 24 and has started a full-time job. The employer offers a 401(k) and matches employee contributions dollar-for-dollar up to 5% of salary. Jordan earns \$50,000 annually and wants to take full advantage of the employer match.

- A. Which account should Jordan consider contributing to?
- B. How much must Jordan contribute annually to receive the maximum employer match? Show your calculation.
- C. How much would Jordan and the employer contribute together over one year, excluding investment gains or losses?

Scenario 2: Priya wants to invest money now to help pay for her daughter's future qualified education expenses. She is interested in an account that offers tax advantages when funds are used for education.

- A. Which account is designed for this purpose?
- B. What is its principal federal tax advantage?
- C. What potential tax consequence should Priya consider if she withdraws money for a nonqualified expense?

Scenario 3: Alex is enrolled in an HSA-eligible high-deductible health plan and wants to save for future qualified medical expenses.

- A. Which account is designed for this goal?
- B. Identify two tax advantages associated with the account.
- C. What happens to unused money at the end of the year?

Scenario 4: Taylor wants to save for retirement and is considering a traditional IRA and a Roth IRA. Taylor expects to have a higher income tax rate during retirement than today.

- A. Which account's tax treatment might be appealing under that assumption?
- B. Explain why.
- C. Would your answer necessarily be the same if Taylor expected a lower tax rate during retirement? Explain.

Scenario 5: Morgan and Riley each invest \$5,000 in the same stock market index fund. Morgan holds the investment in a traditional IRA, while Riley holds it in a Roth IRA.

- A. Does the account type change the underlying investment's market risk?
- B. What important difference exists between the two accounts?
- C. Why should investors consider both the investment and the account in which it is held?

Part 3: Challenge Question

A friend tells you: “I have a Roth IRA, so my investments are tax-free and I can’t lose money.” Identify two errors in this statement and explain each.

1. Problem:

Explanation:

2. Problem:

Explanation:

COACH ANSWER KEY

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Part 1: Know Your Accounts

1. Traditional IRA and Roth IRA.
2. A 401(k). An employer match adds employer money to the employee's retirement account, increasing total contributions.
3. A 529 plan is designed for qualified education expenses; an HSA is designed for qualified medical expenses.
4. Traditional IRA contributions may qualify for a current deduction, while withdrawals are generally taxable. Roth IRA contributions use after-tax dollars, but qualified withdrawals are tax-free.

Part 2: Which Account Fits?

Scenario 1: Jordan

- A. A 401(k).
- B. $\$50,000 \times 5\% = \$2,500$ in annual employee contributions.
- C. $\$2,500$ employee + $\$2,500$ employer = $\$5,000$ combined annual contributions, excluding investment gains or losses.

Scenario 2: Priya

- A. A 529 plan.
- B. Earnings and qualified withdrawals are generally federally tax-free.
- C. The earnings portion of a nonqualified withdrawal may be subject to income tax and an additional tax.

Scenario 3: Alex

- A. A Health Savings Account (HSA).
- B. Accept any two: eligible contributions receive federal tax advantages; earnings grow tax-free; withdrawals for qualified medical expenses are tax-free.
- C. Unused funds generally carry forward to future years.

Scenario 4: Taylor

- A. A Roth IRA may be appealing under the stated assumption.
- B. Contributions use after-tax dollars, while qualified withdrawals are tax-free; paying tax now may be appealing if Taylor expects a higher tax rate in retirement.
- C. Not necessarily. If Taylor expects a lower retirement tax rate, the potential current deduction of a traditional IRA may be more appealing. Eligibility and other circumstances also matter.

Scenario 5: Morgan and Riley

- A. No. The same underlying fund has the same market exposure regardless of account type.
- B. The accounts differ in tax treatment: traditional IRA withdrawals are generally taxable, whereas qualified Roth IRA withdrawals are tax-free.
- C. The investment determines market exposure and potential return; the account's tax treatment can affect the investor's after-tax outcome.

Part 3: Challenge Question

1. Not every Roth IRA withdrawal is automatically tax-free. Tax-free treatment depends on the applicable withdrawal rules.
2. A Roth IRA does not protect against investment losses. Investments held in the account can decline in value.

Coach Notes

Employer matching arrangements vary by plan. HSA contribution eligibility is subject to additional requirements beyond having a high-deductible plan. Avoid treating illustrative account comparisons as individualized recommendations.

Source and Development Notes

Original NIC instructional activity developed using the following references: Federal Reserve Bank of St. Louis, Retirement Account Basics (2024); Federal Reserve Education, Life Goals (education savings context); IRS Publication 970, Tax Benefits for Education; IRS Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans; Voya, Matching Contributions.

Annual contribution limits are intentionally omitted because they change over time.