Season 1 – Episode 4 - IRA 101: Navigating the Intricacies of Traditional and Roth IRAs

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we're opening the vault to discuss a topic that should be on everyone's radar individual Retirement Accounts, or IRAs. We're peeling back the layers of traditional and Roth IRAs, exploring their inner workings, their tax implications, and how they can fit into your financial landscape.

Let's start with the basics. An IRA is a type of investment account that allows you to save for retirement with tax free growth or on a tax deferred basis. There are two main types traditional and Roth IRAs. First, the traditional IRA you contribute pre tax income, meaning the amount you contribute could be deductible and lower your taxable income, and it grows tax deferred. But when you withdraw the money at retirement, you'll have to pay ordinary income taxes on it.

In 2023, the contribution limit for both types of IRAs is 6,500 a year, or 7,500 a year if you're 50 or older. But there are income limits for making deductible IRA contributions if you are also covered under an employer provided retirement plan. For single filers covered by a workplace retirement plan, the tax deduction for traditional IRA contributions phases out between 73,000 or 78,000 of modified adjusted gross income. For married individuals, it is between 116,000 and 136,000. Meaning if you are single and make over 78,000 during the year, you cannot deduct your traditional IRA contribution. You can still contribute to the traditional IRA, you just can't deduct it. If you contribute and you cannot deduct all or part of the contribution, you will have something called basis in your IRA. Most of the time, people contribute to their traditional IRA with pretax dollars, and so their basis is typically zero. But in this instance where you've made some after tax contributions, you will have basis in your traditional IRA. The significance of the basis comes into play when you take distributions in a traditional IRA with only pretax contributions, the entire amount of the distribution is subject to income tax because you haven't paid taxes on those funds yet. But if you have basis, meaning some after tax contributions, part of your withdrawal will be tax free.

The tax free portion of the distribution is proportional to the ratio of your after tax contributions, your basis to the total balance in your IRA. So, for instance, if your IRA contains $100,000 in total and you have $20,000 in basis, then 20% of your distribution will be tax free. It's important to keep track of your basis using IRS form 8606 to ensure that you're not overpaying on your taxes. Now let's discuss Roth IRAs which are a bit different. Your contributions are made with after tax dollars meaning you pay taxes on the money now, but withdrawals in retirement are tax free. This includes earnings on your contributions as well. With Roth, you can't always contribute to them directly. If your income is above certain thresholds, a direct Roth contribution is not allowed. The income limit for Roth IRA contributions in 2023 is modified AGI of 138,000 to 153,000 for single filers and 218,000 to 228,000 for married couples filing jointly.

Now, to get around this income limit, a backdoor Roth IRA strategy can be utilized. This is where you contribute money to a traditional IRA, then convert those funds to a Roth IRA. You'll have to pay taxes on any earnings and on pretax contributions that are converted. This means that any money currently sitting in a traditional IRA or a Simple IRA or a Sep IRA that does not have basis will cause the conversion from the traditional IRA to the Roth IRA to be taxable. So for example, if your zero basis traditional IRA balance is 95,000 before you contribute another 5,000 with the intent of doing a backdoor Roth. So when you do the conversion of the 5000, 95% of the 5000 will be taxable to you. This impact reduces the effectiveness

and frankly the point of doing the backdoor Roth IRA contribution. And so you would like to plan away from this issue.

A way to do that is that if you have a work and the 401k allows for outside retirement account rollovers to the can roll over your traditional IRA to the 401k removing the backdoor Roth IRA tax problem on conversions. So now that you have the money in the Roth a crucial element of the Roth IRA preretirement is the basis the amount of money you put into it. This can be withdrawn tax free and penalty free at any time. That's because you've already paid taxes on this money. You need to be careful with the earnings though. And unless you are 59 and a half or older and the amount is at least five years old the account earnings can be subject to taxes and penalties. So make sure you're over 59 and a half and make sure the account is at least five years old. With regard to penalties, withdrawing money before the age of 59 and a half from either type of IRA usually triggers a 10% early withdrawal penalty.

Now, there are exceptions. For instance, you can avoid the penalty if you use the withdrawal for a first time home purchase, unreimbursed medical expenses, higher education expenses or a series of substantially equal periodic payments, among others. One of the key elements of an IRA is the investment power of contributing and investing the IRA over time. The point of the IRA, of course, is to give yourself a retirement benefit. Being diligent in contributing can have a substantial effect to your funds available in retirement. Let's take a moment to illustrate this with an example. Imagine you're contributing $6,000 a year. You do this religiously for 30 years. And let's assume your investments within the IRA yield a consistent 7% annual return, which is near the average return of the stock market over the long term. So you've contributed a total of 180,000 over 30 years. But due to the compounding effect, your balance would be much higher.

With a 7% annual return, your IRA balance would grow to around $612,000. For a traditional IRA, those earnings have grown tax deferred. For a Roth IRA, those earnings could be withdrawn tax free during retirement. This simple example shows why contributing to an IRA consistently can be such a powerful tool for your retirement planning. And once you've made it to retirement, if you're lucky enough to not need the IRA money for your living expenses, the government requires you to take money out of your traditional IRA so they can get their taxes. These are called required minimum distributions or RMDs. Now, the Secure Act 2.0 increased the RMD age from 72 to 73 for 2023, and it goes to 75 in 2033. This means that once you turn 73 or 75, depending on your current age, you'll have to start taking these withdrawals from your retirement accounts each year.

RMDs apply to most retirement accounts, including traditional IRAs, Simple IRAs and Sep IRAs. Importantly, though Roth IRAs are the exception. They do not have RMDs during the lifetime of the original owner, which is a significant benefit for those considering estate planning. Now, how are RMDs even calculated? The exact amount depends on a few factors your age, the balance in your account at the end of the previous year, and your life expectancy, which is taken from tables provided by the IRS. The most commonly used is the Uniform Lifetime Table, but there are others used in specific circumstances, such as if your spouse is a sole beneficiary and is more than ten years younger than you. To calculate your RMD, you would take the account balance as of December 31 of the previous year and divide it by the distribution period from the applicable IRS table. Now, it's crucial to take these RMDs, as the penalty for not doing so is steep, but actually less steep than it used to be.

Prior to the Secure Act 2.0, before Secure Act 2.0 was passed, the penalty was 50% of the RMD not taken. Now the penalty is 25% of the amount that was not distributed, and the penalty will be reduced to 10% if the IRA account owner withdraws the RMD amount previously not taken and submits a corrected tax return in a timely manner. Another important item discussed with RMDs is something called a qualified charitable distribution or QCD. A QCD is a direct transfer of funds from your IRA payable to a qualified charity. These can be counted towards satisfying your requirement distributions for the year as long as certain rules are met. One key requirement is that you must be at least 70 and a half years old to make a QCD. The maximum annual amount that can qualify for a QCD is $100,000. This applies to the sum of QCDs made to one or more charities in a calendar year.

Now, if you file taxes jointly, your spouse can also make a QCD from their own IRA with the same tax year for up to 100,000. The 100,000 annual amount will be indexed for inflation after 2023. The benefit here is that QCDs are excluded from your income. This is not the case with regular withdrawals from an IRA, even if you use the money to make a charitable contribution later. Because a QCD is not included in your taxable income, it can potentially help you stay below the thresholds for certain taxes and deductions that are tied to your adjusted gross income if you do not itemize your deductions. Completing QCDs effectively acts as a deductible charitable contribution, since income that would have otherwise been taxed as an

RMD is no longer taxable, and therefore effectively you receive a deduction for the charitable contribution. Now, the charity must be a 501(c)(3) organization.

It can't be a private foundation or a donor advised fund. Also, the distribution must be made directly to the charity. You can't withdraw the funds yourself and then donate them. Now, finally, let's delve into how IRAs are taxed at death and the distribution rules for beneficiaries. For traditional and Roth IRAs, the entire balance will be included in your taxable estate for 2023. Your estate is taxable only if your net assets are over 12.6 million for single individuals and 24.12 million for married couples. From an income tax standpoint, for a traditional IRA, the beneficiaries will owe income tax as they take distributions. Roth IRAs, on the other hand, may not have any income tax due for beneficiaries if the account is at least five years old. The Secure Act of 2019 before 2.0, changed the rules for beneficiaries. Under the Secure Act, most beneficiaries are required to fully distribute their inherited IRA within ten years.

But there are exceptions, which is where eligible designated beneficiaries come into play. Eligible designated beneficiaries include spouses, minor children of the original account owner, beneficiaries who are not more than ten years younger than the original account owner, and disabled or chronically ill individuals. For spouses, they have the option to treat the inherited IRA as their own or roll it into their existing IRA. If they choose to treat as an inherited IRA, they can take distributions over their life expectancy. For minor children of the original account owner, they can take out the distributions over their life expectancy, but only until they reach the age of majority, which is 18 years old. After that, the ten-year rule applies for beneficiaries who are not more than ten years younger than the original account. Older Owner they can take distributions over their life expectancy for disabled or chronically ill individuals who can take distributions over their life expectancy.

Being able to stretch out your IRA distributions can be a significant benefit as it allows the funds more potential time to grow tax deferred in the account. We've covered a lot and there's a lot to digest, but understanding these details about IRAs can help you plan your financial future more effectively. Remember, consult with a tax professional before making any significant decisions to ensure you're making the best move for your own unique circumstances.

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