MANAGING YOUR IRAS – PRESENTATION TOPICS

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MANAGING YOUR IRAS

REQUIRED MINIMUM DISTRIBUITIONS:

Managing your IRAs – traditional, 401(k), 403(b) and Roth - to make them last as long as possible is vital for an individual to have an effective retirement. However, the Internal Revenue Code contains many traps and rules that can make that management more difficult.

Distributions from traditional, 401(k) and 403(b) IRAs are included in gross income and taxed as ordinary income (except for distributions of nondeductible contributions but not the compounded income and gains thereon). Long-term capital gains which would otherwise receive favorable tax treatment if earned in a taxable account lose that advantage if earned within taxable IRAs.

Roth IRAs are different. They are created with contributions of after-tax dollars. Most importantly, whereas all original contributions can always be distributed income tax-free, all earnings on contributions as well as capital gains earned on the sales thereof can also be distributed tax-free if two tests are met:

1) five (5) years have expired from January 1 of the year in which the first contribution to the Roth IRA was made. The date any contributions are made after the first is immaterial for future non-tax treatment of those later contributions and earnings and gains thereon; they are also non-taxable. Once you have satisfied the five-year rule for one Roth IRA, you have satisfied it for life for all Roth IRAs; and
2) the distribution must be made on or after one of the following events: the owner turned 59 ½, the IRA owner passed away, so the distribution is made to the estate or a beneficiary; and the distribution is made for first-time qualified home-buyer expenses of up to $10,000.00.

There are specific distribution rules that apply to determine whether the amount received is principal and/or earnings. (See a knowledgeable tax preparer accountant or I.R.S. enrolled agent if you have questions.)

One tax code tripping point for taxable IRAs is the Required Minimum Distribution or "RMD" requirement.

Upon attaining the age of 73 an individual MUST take distributions from traditional, 401(k) and 403(b) IRAs by April 1 of the year after the year in which that age is attained. It is usually best to take the first RMD by December 31 of the year you turn 73 because you must take an RMD by Dec. 31 for each year after the year you turn 73 and you do not want to take two distributions in the same year. If an individual turned 72 during or before 2022, the rules in place at the start of 2022 must be followed.

The amount of the distribution is a specified factor, based on life expectancy, divided into the value of the IRAs as of December 31 of the preceding year. The factor can be found in IRS Publication 590 (at www.irs.gov). There are three life expectancy tables. Table I is for beneficiaries (those who have inherited IRAs). Table II is for married IRA owners whose spouses are both more than 10 years younger than they are and are the sole principal beneficiaries of the IRAs. Every other IRA owner uses Table III.

In years after age 73 is reached you use the value at the close of the previous year. The distribution must be taken by December 31st. The factor increases each year, regardless of the value of the traditional, 401(k) and 403(b) IRA. The distribution is taxed as ordinary income. And, failure to take the full RMD results in a penalty equal to 25% of the amount that should have been distributed. In addition, the penalty is reduced to 10% if the mistake is corrected in a timely manner. This generally means you must distribute the RMD amount before the IRS sends you a notice of deficiency or before the last day of the second taxable year that begins after the year in which the RMD should have been taken, whichever is earlier. You can take the RMD amount(s) any time during the year and on any schedule you like so long as the you take total distributions totaling the minimum amount(s) by December 31st. The RMD must be taken before you can convert to a Roth IRA.

Most importantly, there are no RMDs required from original owners of traditional Roth IRAs. After 2023, the RMD requirement for original owners is eliminated for employer-sponsored Roth accounts, that is Roth 401(k) and Roth 403(b) plans.

For tax reporting purposes, you first determine the RMD amount by aggregating the amounts for each type of non-Roth IRA. You can then take the RMD from each type in any combination you want but you cannot combine amounts across each non-Roth IRA type. That is, you total the amount due for each IRA in each category of non-Roth IRA and can then satisfy the amount due from any individual category from the accounts in that category in any ratio you want. For example, if you have two (2) traditional IRAs having values of $150,00 and $200,000, one 401(k) worth $300,000 and one 403(b) worth $50,000, you can combine the amounts due from the traditional IRAs and satisfy the RMD due on the $350,000 total from either or both traditional IRA accounts in any amount you want but you cannot satisfy the RMD due from the 401(k) or 403(b) IRAs other than from those two accounts themselves, separately. You cannot combine the $150,000, $200,000, $300,000 and $50,000 values and then take the RMD due on a $700,00 value from all or any part of the non-Roth IRAs.

Finally, an RMD does not have to be taken in cash. The distribution of stock, ETF and/or mutual fund can be made in kind and placed in a taxable account with a basis for future tax purposes equal to the fair market value of the property received on the day of the distribution regardless of what happens to the asset's price the rest of the year. You must be sure the value of the property distributed at least equals the RMD for the year. When you sell the property you will pay capital gains tax only on the appreciation that occurred after the distribution.

As RMDs increase over time, gross income and adjusted gross income (AGI) also increase. The amount of your AGI determines whether you are subject to what are called "stealth taxes," amounts taken from you without an increase in income tax rates. These include the Medicare premium surtax, tax on Social Security benefits, reductions in personal and dependent exemptions and itemized deductions, the alternative minimum tax, and more.

You can temper the effect of RMDs by (a) taking money out of the IRAs before you must (and if invested in a taxable account any appreciation can ultimately become a long-term capital gain), (b) convert the traditional IRA to a Roth IRA, (c) let the RMD happen but use the after-tax cash amount to buy permanent life insurance and (d) draw down the IRA early, pay the tax, and purchase permanent life insurance. And, you can always take more than the minimum RMD amount (so long as you are willing to pay any income due). However, any excess above the RMD amount will not be used as a credit or other reduction when you compute the next year's RMD.

CONVERSION OF TRADITIONAL IRAs TO ROTH IRA

An individual can covert a traditional IRA into a Roth IRA but not without a cost. Taxes must be paid as though the amount converted had been distributed to the taxpayer from the traditional IRA. If that IRA contains nondeductible contributions the conversion of them is not taxed. The amount of the conversion is determined by the value of the assets on the conversion date. This may be no later than December 31st to be effective for the year. Taxpayers who are already subject to the RMD rules must take the required distribution for the year of conversion. A required distribution cannot be avoided by a conversion but a conversion made before year-end will reduce the value of an IRA for purposes of computing a future RMD amount. You can covert only money that remains in the IRA after the year's RMD. Again, The RMD for any year must be taken before you can convert any amount in the traditional IRA.

Conversion rules are simple. The difficulty is in determining when it makes sense to pay the cost of converting. Various factors and assumptions (beyond the scope of this presentation) may be involved. The bottom line is: will the taxpayer be better off in continuing to own the traditional IRA compared to the anticipated results of the conversion?

Factors to consider are:

1) Is the source for paying the income due on conversion found inside or outside the IRA? The more money that remains in the IRA to benefit from tax-free growth the more advantageous it is to convert. Therefore, a conversion is less beneficial if money to pay the tax must be taken out of the traditional IRA itself.

2) How long will the money remain in the Roth IRA for income and gains to accumulate before distributions begin? Simply put, the longer the better. And probably the best if the original owner does not intend to take any distributions but intends to pass the Roth IRA amount to heirs or a charity.

3) Will there be a difference between the tax bracket at the time of conversion and the bracket at the time of distribution(s)? The more the future bracket will decline the less sense it makes to convert and pay taxes at the current rate.

4) How much of the traditional IRA will be converted? Any portion of the IRA can be converted; conversion is not an all-or-nothing proposition. Conversion can take place in stages over several years. However, make sure you have calculated whether the amount to be converted, and therefore included in income, will cause any part of the income to be taxed in a higher tax bracket than would otherwise apply to taxable income.

5) Will Social Security benefits be taxed? A conversion can potentially reduce taxes on Social Security benefits. Distributions from a traditional IRA are included in gross income, raising the amount of benefits that are taxable. Nontaxable distributions from a Roth IRA are not included in gross income and so do not increase the potential taxable amount.

6) Will the inclusion of the converted amount in income cause the imposition of or an increase in “stealth taxes”?

7) Has the IRA value decreased due to market changes? Because of the lower value, the same number of shares of stocks or funds can be converted at a lower ultimate tax cost than at the start of the year. When you believe the values will rebound over time, the shares are being converted to future tax-free income at a discount.

So, how do you decide to convert? There are a few general rules to keep in mind:

1) The longer the Roth IRA will be able to compound results before distributions begin, the more sense a conversion makes.
2) The higher the expected investment rate of return on the Roth IRA, the more a conversion makes sense.
3) A conversion makes more sense if the income taxes due are paid from non-IRA funds which have already been taxed.
4) A conversion makes more sense if the income tax rate will increase after traditional IRA distributions would begin.
5) Do the required number crunching. Stock brokers may offer free calculators to project the results of a conversion. See vanguard.com, fidelity.com and troweprice.com. Also consult financial publication websites.

You can change your mind.

The tax law allows a conversion to be reversed as late as the date the tax return for the year is due. This is known as a “recharacterization. No taxes will be due. A recharacterization should be considered when the value of the IRA decreases significantly after the conversion. If the conversion is not reversed, then taxes due are based on the IRA value on the conversion date. The taxpayer would be paying taxes on wealth that no longer exists.