Money Matters

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Skloff Financial Group Question of the Month
By Aaron Skloff, AIF, CFA, MBA

Q: We read your article 'Pre-tax Versus Roth Contributions to Retirement Accounts – Which Is Better?' Part 1 and Part 2. Are all withdrawals from Roth IRAs tax free?

The Problem — Knowing When Roth IRA Withdrawals Are or Are Not Tax Free
Generally, withdrawals from Roth IRAs are tax free. According to the IRS, "If you satisfy the requirements, qualified distributions are tax-free". It seems the IRS always has an 'if', 'but' or 'subject to' up its sleeve that can trip you up. And those trip ups can be costly. Non-qualified distributions are subject to income taxes and a 10% penalty.

The Solution — Knowing the Exceptions to Tax Free Roth IRA Withdrawals
Withdrawals from most savings vehicles are subject to income taxes or capital gains taxes. Withdrawals from most retirement accounts are subject to income taxes. Roth IRAs are considered the holy grail of retirement vehicles because you and your beneficiaries can make tax free withdrawals of contributions and gains. So, avoid unnecessary withdrawals at all costs. Avoiding withdrawals permits further tax free wealth creation and preservation. Most retirement accounts, including Traditional IRAs, mandate withdrawals in the form of Required Minimum Distributions (RMDs) by age 73. Roth IRAs do not mandate RMDs for the owner. Furthermore, your spouse can inherit your Roth IRA and continue avoiding RMDs. There are tax implications on Roth IRAs if you do not follow the rules. We examine numerous withdrawal scenarios and the rules associated with them below.

Contributions. You can withdrawal your contributions (principal) at any time and at any age on a tax free and penalty free basis.

Meeting the Age 59 ½ Rule. You can withdrawal your contributions and gains on a tax free and penalty free basis if you are at least 59 ½ years old and have met the 5-year rule. The 10% penalty is removed at age 59 ½.

Meeting the 59 ½ Rule and the 5-Year Rule. The IRS defines the 5-year rule as, "…the 5-year period beginning with the first taxable year for which a contribution was made to a Roth IRA (including a conversion or a rollover from a qualified retirement plan) set up for your benefit". Let's look at an example where you establish a Roth IRA at the age of 56. At the age of 60 you meet the 59 ½ rule, but not the 5-year rule. At the age of 60, you can withdrawal your contributions tax free, but your gains would be subject to income taxes. At the age of 61, you can withdraw your contributions and gains tax free.

Before the Age of 59 ½ 5-Year Rule for Roth IRA Conversions. While withdrawals of Roth IRAs are based on a single 5-year rule for all Roth IRAs, each Roth IRA conversion has its own 5-year rule for those under the age of 59 ½. Let's look at an example where you convert from a Traditional IRA to a Roth IRA at the age of 50 (conversion 1) and another at age 53 (conversion 2). At the age of 55, you meet the 5-year rule on conversion 1, but not yet on conversion 2. You can withdrawal the principal on conversion 1 tax free, but the withdrawals of gains are subject to income taxes and a 10% penalty. You can withdrawal conversion 2, but since it is less than 5 years old, it is subject to a 10% penalty on the principal and gains, and income taxes on the gains. Withdrawals are evaluated in order of contributions, conversions, then gains. After age 59 ½ there are no penalties, but the 5-year rule still applies to gains.

Before the Age of 59 ½ Due to a Disability. Even if you receive a distribution before you are age 59½, you may not have to pay the 10% additional tax if you are totally and permanently disabled. But, the 5-year rule still applies.

Before the Age of 59 ½ Due to an Inheritance. Except for a spouse, who can inherit a Roth IRA as their own, beneficiaries receive the proceeds of Roth IRAs as an Inherited Roth IRA. Unlike the original Roth IRA owner that can avoid RMDs, Inherited Roth IRA owners are subject to RMDs if the death occurred before 2020. If the death occurred in 2020 of thereafter, the Roth IRA must be withdrawn within 10 years, starting in the year after the death. Fortunately, withdrawals are tax free and penalty free at any age. But, the 5-year described above carries over to the Inherited Roth IRA. Translation: if the original Roth IRA is four years old, the Inherited Roth IRA owner will have their gains subject to taxes (but not penalties) until the 5-year period is met. There are some exceptions for eligible designated beneficiaries.

First Time Home Purchase. You can withdraw up to $10,000 in earnings to purchase a home on a tax free and penalty free basis at any age. But, the 5-year rule still applies to earnings. The $10,000 limit is a lifetime maximum limit. You can also qualify for the exemption if you are using the money to buy your own home or for your spouse, children, grandchildren, or parent(s).

Higher Education Expenses. Withdrawals for higher education expenses are tax free and penalty free if used for the needs of: you, your spouse, children, grandchildren or great-grandchildren. Note: the 5-year rule applies, and withdrawals can be counted as untaxed income for financial aid consideration.

Action Steps
Work closely with your Registered Investment Adviser (RIA) and tax professional in evaluating or completing Roth IRA contributions and withdrawals. Since Roth IRAs are such powerful estate and retirement planning vehicles, withdraw from them only when necessary.

Aaron Skloff, Accredited Investment Fiduciary (AIF), Chartered Financial Analyst (CFA), Master of Business Administration (MBA) is CEO of Skloff Financial Group, a Registered Investment Advisory firm specializing in financial planning, investment management and benefits for small to middle sized companies. He can be contacted at www.skloff.com or 908-464-3060.