

Money Matters

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Skloff Financial Group Question of the Month

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Q: We read ‘Are All Roth IRA Withdrawals Tax Free?’ Part 1. Can you give examples and tax impact of Roth IRA withdrawals?

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. 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.

The Solution – A Side by Side Comparison of Roth IRA Withdrawals

By examining scenarios on a side by side basis, we can see which withdrawals are tax free and which are not. The examples and chart below are based on a 30% income tax rate.

Contributing at Age 30 and Withdrawing Contribution at Age 40. You contribute \$5,000 at age 30. Your investment grows to \$12,000 at age 40 and you withdraw your \$5,000 contribution. There are no tax implications, as contributions can always be withdrawn tax free.

Contributing at Age 30 and Withdrawing Contribution and Gain at Age 40. You contribute \$5,000 at age 30. Your investment grows to \$12,000 at age 40 and you withdraw your \$5,000 contribution and \$7,000 gain. There are no tax implications on your contributions, as contributions can always be withdrawn tax free. Although the 5-year rule is met, the gains are subject to income taxes and a 10% penalty because you were not age 59 ½ or older.

Contributing at Age 30 and Withdrawing Contribution and Gain at Age 60. You contribute \$5,000 at age 30. Your investment grows to \$48,000 at age 60 and you withdraw your \$5,000 contribution and \$43,000 gain. There are no tax implications on your contributions, as contributions can always be withdrawn tax free. Since the 5-year rule and age 59 ½ rule are met, the gain is income tax and penalty free.

Contributing at Age 58 and Withdrawing Contribution and Gain at Age 60. You contribute \$5,000 at age 58. Your investment grows to \$6,000 at age 60 and you withdraw your \$5,000 contribution and \$1,000 gain. There are no tax implications on your contribution, as contributions can always be withdrawn tax free. Although the 59 ½ rule is met, the gain is subject to income taxes and a 10% penalty because you did not meet the 5-year rule.

Converting Traditional IRAs at Age 50 and Withdrawing Conversion at Age 54. 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. You convert a \$5,000 Traditional IRA to a Roth IRA at age 50. Your conversion grows to \$7,000 at age 54 and you withdraw your \$5,000 conversion. Since you did not meet the 5-year conversion rule, the \$5,000 withdrawal is subject to a 10% penalty.

Converting Traditional IRAs at Age 50 and Withdrawing Conversion and Gains at Age 54. You convert a \$5,000 Traditional IRA to a Roth IRA at age 50. Your conversion grows to \$7,000 at age 54 and you withdraw your \$5,000 conversion and \$2,000 gain. Since you did not meet the 5-year conversion rule, the \$5,000 withdrawal is subject to a 10% penalty. Since you did not meet the 59 ½ rule or the 5-year rule, the \$2,000 gain is subject to income taxes and a 10% penalty.

	Contributing at 30 Withdraw Contribution at 40	Contributing at 30 Withdraw Contribution at 40 Withdraw Gain at 40	Contributing at 30 Withdraw Contribution at 60 Withdraw Gain at 60	Contributing at 58 Withdraw Contribution at 60 Withdraw Gain at 60	Contributing at 58 Withdraw Contribution at 60 Withdraw Gain at 60	Contributing at 58 Withdraw Contribution at 60 Withdraw Gain at 60	Converting at 50 Withdraw Conversion at 54	Converting at 50 Withdraw Conversion at 54 Withdraw Gain at 54
Roth IRA Contribution	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000	N/A	N/A
Roth IRA Conversion	N/A	N/A	N/A	N/A	N/A	N/A	\$5,000	\$5,000
Withdraw Contribution	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000	N/A	N/A
Withdraw Conversion	N/A	N/A	N/A	N/A	N/A	N/A	\$5,000	\$5,000
30% Income Tax	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
10% Tax Penalty	N/A	N/A	N/A	N/A	N/A	N/A	(\$500)	(\$500)
Net Withdrawal	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000	\$4,500	\$4,500
Withdraw Gain	N/A	\$7,000	\$43,000	\$43,000	\$43,000	\$1,000	N/A	\$2,000
30% Income Tax	N/A	(\$2,100)	N/A	N/A	N/A	(\$300)	N/A	(\$600)
10% Tax Penalty	N/A	(\$700)	N/A	N/A	N/A	(\$100)	N/A	(\$200)
Net Withdrawal	N/A	\$4,200	\$43,000	\$43,000	\$43,000	\$600	N/A	\$1,200
Total Withdrawal	\$5,000	\$9,200	\$48,000	\$48,000	\$48,000	\$5,600	\$4,500	\$5,700

Action Steps

Defer Roth IRA withdrawals as long as possible. Roth IRAs are one of a few estate planning and retirement planning vehicles that provide tax free growth and tax free withdrawals. Avoid unnecessary taxes by staying within the IRS guidelines. Work closely with your Registered Investment Adviser (RIA) to reduce your taxes, and grow and preserve your wealth.

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