

MOLDENHAUER ASSOCIATES

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August has presented a break from the “chaos of the moment” that has plagued 2024 (and the last couple of years). Is it possible not to get inspired and emotional when watching athletes, who have trained their entire life, put years of effort on the line for a moment of glory?

I was a competitive swimmer growing up. This developed an appreciation of hard work, discipline, competitiveness, success and heartbreak. Nothing I have ever achieved compares to the successes we’ve seen by this year’s medal winners. We’re in an unprecedented time where we have seen GOATs (greatest of all time) cement their sporting legacy; Katie Ledecky added 4 medals to her lifetime total, and we witnessed Simone Biles orchestrate one of the most impressive comebacks of all time (at the ripe old age of 27).

Every event is influenced by many factors that will determine an athlete’s success. How hard did they train? Did they eat the right pre-game meal? How much wind is there? Some of these factors can be controlled by the athletes, but others are not. Elite athletes are great at focusing on the things they can control.

In a way, this is analogous to financial success. Earlier this month was the largest single day sell off we’ve seen lately. Inflation, though coming down, still impacts the decisions of every day Americans. There are two wars, and we certainly hope they don’t escalate (as is always the fear). I was talking with someone last month, and we were talking about how crazy the election is...and were grateful that it couldn’t get any crazier. Then it did.

My point in writing this isn’t to get political; it’s actually the opposite. Focus on the things we can control. Make smart decisions. Focus on the long term. Be kind and decent. Contribute to the world, so that it becomes the one you want to live in or leave behind for your children or grandchildren.

The most important lesson I learned from all of my years as a swimmer was that I wasn’t competing against other athletes; I was competing against myself...to be the best that I could be. Something I read recently about the Olympics was an athlete saying that, even though it is a competition, and they want to win, they still wanted their competition to have a great performance too. If we all take this type of positivity into the remainder of 2024, maybe we’ll all start to feel better about where we’re heading.

Brett Moldenhauer

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BACKDOOR ROTH IRA CONTRIBUTIONS: A WAY TO CATCH UP ON RETIREMENT SAVINGS

Retirement planning is complicated so many individuals put off saving, thinking that retirement is years away—until it isn't. Then, in their 40s and 50s, they start to panic and wonder how they'll catch up. One strategy, made possible beginning in 2010 by a provision to the Tax Increase Prevention and Reconciliation Act of 2005, presents a way for some individuals to potentially put away more money for retirement, in a tax-advantaged way.

A Strategy That Works Around Income Phaseouts

One of the reasons people may invest in traditional IRAs is because contributions are tax deductible—but only for individuals within a certain income threshold and who are covered by a workplace retirement plan. Individuals with income over the limit can still contribute, but the contribution amounts are not deductible. A similar income phaseout exists for those wanting to contribute to Roth IRAs, whether or not they are covered by a workplace retirement plan; once they make a certain amount of money, the opportunity is no longer available. Or is it?

Although the 2010 provision to the tax act retained modified adjusted gross income (MAGI) limits on Roth IRA contributions, it eliminated the MAGI limits on Roth IRA conversions. As a result, anyone who earns too much to contribute to a Roth IRA (and to make tax-deductible contributions to a traditional IRA) can now fund a Roth IRA by making a nondeductible contribution to a traditional IRA and then converting that amount to a Roth IRA—in some cases, tax free.

Known as a backdoor Roth IRA contribution, this strategy can be highly effective for creating tax-free income in retirement, but it's also quite complex. So, it is important to understand the rules for using this strategy and what circumstances may make it beneficial.

If It's So Complicated, Why Bother?

There are many benefits to accumulating retirement assets in a Roth IRA, including:

- Tax-free growth
- Freedom from required minimum distributions, so assets can grow tax advantaged for a longer period of time
- The ability to accumulate potentially tax-free assets for beneficiaries

With the backdoor Roth contribution strategy, however, comes another benefit for individuals who have been phased out of being able to contribute to a Roth IRA in the usual way: the ability to put away more money for retirement.

Take, for example, a married couple in their 40s who file jointly. Both employed, they have maxed out their 401(k) contributions, but neither of them owns an IRA because their MAGI has precluded them from making deductible IRA contributions, as well as Roth IRA contributions. Because they didn't start saving for retirement as early as they should have, they need to find a way to catch up on their savings. What can they do?

They can each make a nondeductible IRA contribution¹ and immediately convert it, tax free, to a Roth IRA. Hypothetically, if each of them contributes \$6,000 annually with this backdoor strategy, with a conservative rate of return of 5 percent, over 20 years they each could potentially accumulate \$208,316.

The Right Individuals for This Strategy

The backdoor Roth IRA strategy is commonly used with individuals who earn too much to make deductible IRA contributions or contribute to a Roth. For these individuals, it's more advantageous to hold assets in a Roth IRA instead of a traditional IRA, as the investment earnings in the Roth will grow tax free.

Other individuals who may benefit are those with a long-time horizon to retirement, as well as those who have maxed out their 401(k) contributions.

This strategy can, in some ways, benefit almost anyone, but some circumstances may make it more beneficial for some.

Individuals without existing IRAs. The backdoor contribution strategy works best for individuals who don't currently have an IRA. In this case, when they make a nondeductible contribution to a new traditional IRA and then convert it to a Roth, the conversion is tax free, unless there were earnings in the account during the time between the initial contribution and the conversion. For this reason, it is best to convert immediately after making a nondeductible contribution.

Individuals with existing IRAs. For individuals who already have IRAs, things can be more complex, although still beneficial. The pro rata rule requires individuals who contribute to and maintain money in multiple IRAs, including SEP and SIMPLE IRAs, to aggregate the account balances. If the IRAs have been funded with both nondeductible and deductible contributions, or if there is any pretax money within the accounts, income tax will be owed on the previously untaxed amounts. This means that individuals using the backdoor contribution strategy may owe taxes on the conversion.

Keeping Track of Nondeductible Contributions

When considering the backdoor Roth IRA strategy, it is important to understand the tax implications (if any), how they are determined, and how they are tracked. Once there are after-tax dollars in one traditional IRA, all IRAs are affected, and any distributions or conversions must consist

of proportionate amounts of both pretax and after-tax dollars until all the IRAs are closed.

Under the aforementioned pro rata rule, the formula for calculating which portion of the conversion amount is tax free is based on the ratio of nondeductible contributions to the market value of all IRAs, as follows:

Nondeductible contributions ÷ Total value of all IRAs = % of conversion amount that is tax free

For example: Jane has \$200,000 in aggregate IRA balances. Of that, \$50,000 is composed of nondeductible contributions. Jane wants to convert \$20,000 to a Roth IRA this year. Because of the pro rata rule, only 25 percent (\$5,000) of the \$20,000 will be tax free. Even though this probably isn't the result she wanted, it's not a complete disaster, as she now has \$15,000 of post-tax basis left over that will eventually come out tax free.

Rules for filing. There are specific tax filing requirements for calculating and tracking after-tax amounts. Failure to track after-tax amounts or report these amounts properly can have tax consequences. Because proper filing and recordkeeping are so imperative—and using this strategy can be complex—it's important for individuals to work with both their financial advisor and CPA.

Is a Backdoor Roth IRA strategy right for me?

Although a simple solution is to save early and often, it's important for individuals to understand all the strategies available to help them catch up or get ahead. When used properly, funding a Roth IRA with backdoor contributions can be a great way to boost retirement savings.

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1 Subject to contribution and distribution limits set annually by the IRS.

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TRADITIONAL IRA VS. ROTH IRA: CHOOSING THE BEST FIT

IRAs are a type of savings account designed to help you put money away for retirement in a tax-advantaged way. Two of the most common types are traditional and Roth IRAs. How do you know which one you should invest in? There are several factors to consider, so let's take a closer look at their similarities and differences to help you choose the best fit.

The similarities between traditional and Roth IRAs include the following:

- **Contribution limits:** Total annual contributions to your traditional and Roth IRAs combined cannot exceed \$7,000 if you are younger than 50 (\$6,500 in 2022) or \$8,000 if you are 50 or older (\$7,500 in 2022).
- **Contribution deadline:** The deadline is the same as your tax return filing deadline (not including extensions).
- **Withdrawals:** You can withdraw money at any time, but distributions may be subject to tax and penalty. For traditional IRAs, withdrawals prior to age 59½ may be subject to a 10 percent premature withdrawal penalty, unless an exception applies. For Roth IRAs, withdrawals of the principal are tax- and penalty-free. If you are younger than 59½ and have had the account for less than five years, however, you may have to pay taxes and/or a penalty on any earnings withdrawn.
- **Rollovers:** Direct rollovers are accepted from outside qualified retirement plans (i.e., 401(k)s), and they may be taxable.

There are, however, some key differences between these account types, as summarized below:

- **Traditional IRAs**
 - Contributions may be tax-deductible, depending on your income level.
 - Contributions grow tax-deferred, meaning you pay taxes only when you withdraw the money.
 - You must begin taking required minimum distributions (RMDs) at age 73.¹
- **Roth IRAs**
 - Not everyone is eligible to contribute; income restrictions apply.
 - Contributions are not tax-deductible. But distributions are tax-free if the account has been open for at least five years and the account owner is age 59½ or has qualified for an early withdrawal exception.
 - Roth IRAs do not have RMDs.

There are a lot of details to take into consideration before deciding on which account you would like to open, and it's important to be well-informed before making a decision. If you have further questions regarding either type of IRA and which one would be best for you, don't hesitate to contact us.

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1 For individuals who turned age 70½ before January 1, 2020, RMDs must begin at age 70½. For individuals who turned 72 between January 1, 2020, and December 31st, 2022, RMDs must begin at age 72. For individuals who turn 73 after January 1, 2023 RMDs must begin at age 73.

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UPCOMING EVENTS:

Our upcoming seminars are at:

The Roycroft Inn

Tuesday, September 17, 2024 at 6 p.m.
40 S Grove Street
East Aurora, NY 14052

Orchard Park Country Club

Thursday, September 19, 2024 at 6 p.m.
4777 S Buffalo Street
Orchard Park, NY 14127

Steelbound Brewery & Distillery

Tuesday, September 24, 2024 at 6 p.m.
243 West Main Street
Springville, NY 14141

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