



In the fourth and final article focused on retirement within our Wealth Council Insights Education Series, we will focus on the power of compounding as it relates to the timing of starting retirement plan contributions, as well as when to begin taking Required Minimum Distributions (RMDs).

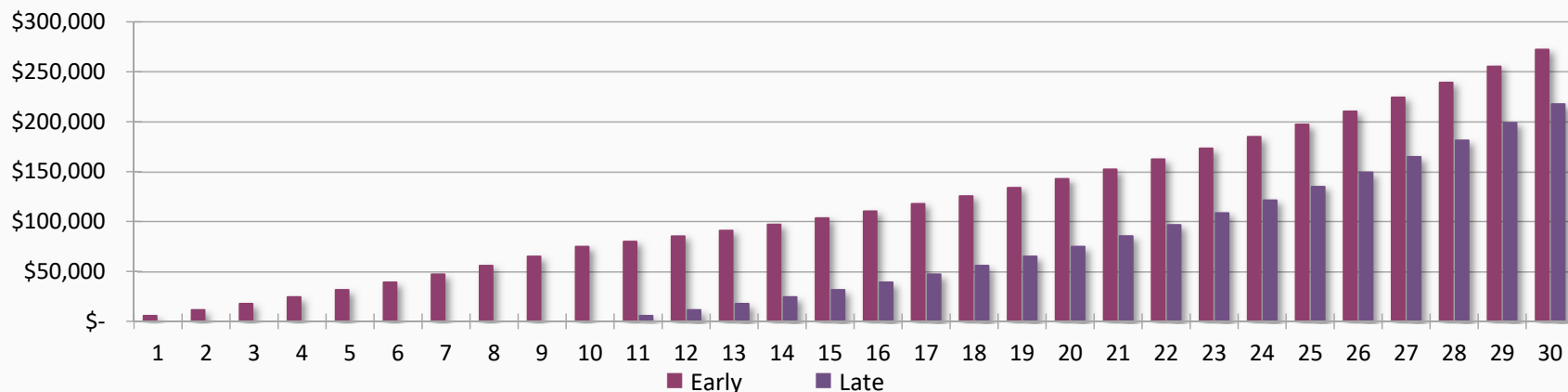
THE POWER OF COMPOUNDING

The effect of compounding over long periods of time can result in amazing differences in outcome. When deciding when to begin contributing to a retirement account, it is important to keep these differences in mind. To illustrate the importance of timing, consider the following two scenarios. In the first scenario, you start making contributions early in your career, deciding at age 25 to contribute \$5,500 for 10 years into an IRA earning 6.5%. In the second scenario, you delay making that

same \$5,500 contribution until age 35 and make contributions for 20 years. The “you” in the first scenario would end up with nearly \$60,000 more in your IRA despite only making contributions for 10 years.

You may have already reaped the benefits of this strategy, but do not hesitate to pass along your wisdom to your children and grandchildren as they begin saving for their future. Consider making annual exclusion gifts to them, with the condition that they invest a portion of the gift into a Roth IRA while they are in a low tax bracket. This would allow those gifts to grow tremendously over the years thanks to the power of compounding, and would also have the advantage of allowing them to take tax-free distributions in the future when their tax bracket is much higher.

COMPOUNDING COMPARISON





REQUIRED MINIMUM DISTRIBUTIONS (RMDs)

“The IRS is not going to let you accumulate tax-deferred funds forever... eventually they will take their piece of the pie!”

Traditional IRA

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Per the SECURE 2.0 Act of 2023, effective 1/1/2023, the age for taking the initial RMD increased to age 73. Those who turned 72 in 2022 and did not take their initial RMD by year-end, still must take the initial RMD by April 1, 2023. Effective 1/1/2033, the RMD age will increase to age 75.

The minimum distribution amount for each year is determined using a life expectancy table. The table provides a “factor” that will be used in conjunction with your previous year-end balance to calculate the RMD. For example, if you have a \$1,000,000 retirement plan balance on 12/31/22 and you turned 75 this year, your life expectancy factor is 24.6 and you will need to take a taxable distribution of \$40,650. These factors, but not necessarily the amount of the distributions, reduce slightly each year the participant ages. The life expectancy table changed for the first time in nearly 20 years in 2022, resulting in slightly lower distribution requirements.

If you are still working at age 72, you may continue to defer taking RMDs from the 401(k) of the company you currently work for (if you do not own more than 5% of said company), but you must begin taking RMDs from all of your other Traditional retirement plans.

Roth IRA

Roth IRAs are another story...since contributions were made with after-tax dollars, there are no RMDs and the distributions (up to the amount contributed) are not taxed upon withdrawal. Earnings on qualified distributions following certain criteria (made a minimum of five years from the beginning of the year for which you first set up and contributed to the Roth IRA, made on or after age 59½, etc.), are neither included in gross income nor are they subject to the 10% penalty for early withdrawals.

Inherited IRA

Inherited IRAs (aka BDAs – Beneficiary Distribution Accounts), including Traditional AND Roth vehicles, each have their own set of rules on distributions. If the account owner died on or before December 31, 2019, these types of accounts are subject to the old RMD rules. The distributions will be based on the new life expectancy factors, even if distributions have been made for years. The amount must be adjusted based on the initial year started, subtracting one from that factor each year until present year to accomplish the required one-time reset.

If the account owner died on or after January 1, 2020 and you are not the surviving spouse (with a few exceptions), you must take the full distribution within 10 years of the account owner’s death. In addition, if the Traditional IRA owner had begun taking his/her RMDs during lifetime, the beneficiary must take an RMD each year based on the longer of his/her life expectancy or the account owner’s life expectancy.



In a nutshell, distributions from an inherited Traditional IRA are taxable to the extent the original contributions were deductible. Distributions from inherited Roth IRAs are tax-free if the owner's first contribution occurred at least five years ago. Investment earnings are taxable if that condition isn't met, however.

Failure to take the RMD in a given year results in a 25% penalty (effective 1/1/2023) on the amount that should have been withdrawn, reduced further to 10% if failure to take an RMD is corrected in a timely manner.

CONCLUSION

Starting contributions as early as possible, making the largest contributions that your cash flow can allow and then delaying distributions from your retirement plans for as long as possible will provide you the highest and best outcome for your retirement savings in the long run. Retirement planning can be complex as there are many rules regarding contributions, distributions and taxation depending upon what type of retirement plan(s) you invest in. Your Oxford team of advisors is positioned to help take a deeper dive into all the various types of plans available, provide you with in-depth modeling of various retirement scenarios and work in coordination with your CPA to determine the best type of plans and timing of withdrawals for your particular situation.

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