Advanced Markets Matters

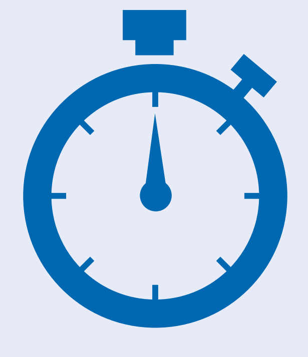
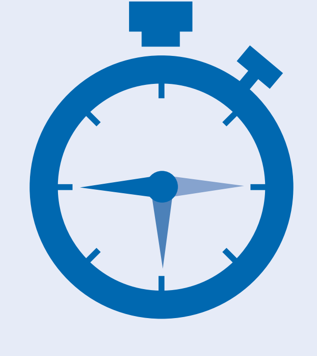
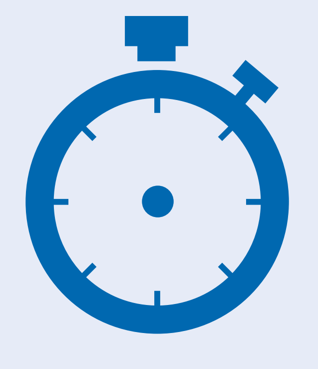
Roth IRA Opportunities

A Financial Professional's Guide

Tax Diversification: Pay Now, Later, Never

Everyone knows clients shouldn't put all their eggs in one basket — better known as "asset diversification." However, not everyone knows that when it comes to retirement planning, tax diversification may be just as important.

Tax diversification may mean more money for retirement:

Tax-Me-Now	Tax-Me-Later	Tax-Me-Never
Stocks, Bonds, Mutual Funds	IRAs, QRPs, Nonqualified Annuities	Roth Accounts, Municipal Bonds, Life Insurance
Retirement income from stocks, bonds, mutual funds, real property or a closely held business interest is generally considered currently taxable. These **tax-me-now** investments produce dividends, interest, capital gains, rents, etc.	Most investments used to provide retirement income are tax-deferred — often pre-tax qualified accounts such as traditional IRAs and qualified retirement plans (QRPs) or nonqualified annuities. These **tax-me-later** investments are generally only taxed when distributions begin.	Nontaxable and tax-advantaged investments, or **tax-me-never** investments, produce income/distributions on a tax-free basis. While there are circumstances in which these investments are subject to income tax, generally they are sheltered from future income taxation.
		

Consider the implications of tax diversification. Having access to tax-free income during retirement not only lowers taxable income in that stage of life, but it can also potentially:

- Lower tax rates on ordinary income, capital gains and qualified dividends
- Lower the amount of Social Security benefits subject to taxation
- Lower the amount of Medicare premiums owed

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How Tax-Free Income Lowers Tax Rates

Ours is a progressive tax system. For instance, a married couple having $100,000 of ordinary income would cross the 10-, 12- and 22-percent ordinary income tax brackets. Thus, the higher their taxable income, the higher their marginal tax rate (the percentage taken on the next dollar of taxable income). If clients keep their taxable income within the lower brackets for their filing status, they can avoid those higher marginal tax rates. Distributions from "tax-me-never" investments don't increase taxable income.

How Tax-Free Income Lowers Social Security Benefits Subject to Taxation

The amount of Social Security benefits that are included in a client's income (and thus, subject to tax) depends on their provisional income. To determine provisional income:

- Start with adjusted gross income (AGI) and subtract the Social Security benefit
- Add any non-exempt interest
- Calculate 50 percent of the Social Security benefit and add that amount to the previous total

The lower the AGI, the better the chances of decreasing or even eliminating the amount of Social Security benefits subject to income tax. Of course, distributions from tax-me-never investments don't increase AGI (although tax-exempt interest from municipal bonds is included in provisional income).

How Social Security Benefits are Taxed		
Tax Filing Status	**Provisional Income**	**Social Security Benefit**
Individual	Less than $25,000	Not Taxable
	$25,000 – $34,000	Up to 50% is Taxable
	More than $34,000	Up to 85% is Taxable
Joint	Less than $32,000	Not Taxable
	$32,000 - $44,000	Up to 50% is Taxable
	More than $44,000	Up to 85% is Taxable

How Tax-Free Income Lowers Medicare Premiums Owed

Medicare Part B and Part D premiums are subject to "income-related monthly adjustment amount" (IRMAA) surcharges. These surcharges are applied based on modified adjusted gross income (MAGI), which in this case is AGI plus any tax-exempt bond interest. As opposed to a progressive income tax, each of the four surcharge tiers are "cliff" thresholds. This means that even $1 of income above the threshold results in the entire (higher) surcharge amount being applied. High-income retirees can meet these income thresholds fairly quickly, resulting in Medicare Part B and D premiums becoming more of an expense.

Tax-Me-Never Investments

Tax-me-never investments can provide retirees with flexibility, provide opportunities to control the timing of income and, ultimately, increase the amount of after-tax retirement income.

Being able to withdraw tax-free income from a Roth IRA for an emergency home repair, for example, would not increase a retiree's taxable income for that year. Taking that extra money from a traditional IRA or other pre-tax qualified plan could drastically increase that retiree's income.

Two Ways to Create Roth IRAs

Roth IRAs are a popular tax-me-never investment option. While contributions are taxed upfront, withdrawals of contributions and potentially even earnings are tax-free. In addition, Roth IRAs are not subject to the required minimum distribution rules that apply to other IRAs and QRPs during lifetime.

1. Contribute directly to a Roth IRA with after-tax dollars.

Contribution Limits

- If single, annual contribution will be the lesser of $5,500 or 100 percent of compensation. The $5,500 limit applies to combined contributions to both a traditional IRA and Roth IRA.
- If married and filing jointly, annual contribution limit is the lesser of $11,000 or 100 percent of compensation. Spouses must maintain separate IRAs. The $5,500 limit applies to each spouse separately.
- If age 50 (by December 31) or older, catch-up contributions of an additional $1,000 each year are permitted, making annual contribution limit the lesser of $6,500 or 100 percent of compensation.

Eligibility

- A Roth IRA may be established and contributed to if there is earned income and modified adjusted gross income (MAGI) falls within certain limits. There is no age limit on the ability to contribute.
- If single, the full amount may be contributed as long as MAGI is equal to or less than $120,000. Contribution amount will be limited if MAGI is greater than $120,000, but less than $135,000. It will be eliminated completely if MAGI is $135,000 or greater.
- If married and filing jointly, both spouses may each contribute the full amount as long as MAGI is equal to or less than $189,000. Contributions will be limited if MAGI is greater than $189,000 and less than $199,000. They will be eliminated completely if MAGI is $199,000 or greater.
- If married filing separately, contribution amount is limited between $0 and $9,999. It is eliminated completely if MAGI is $10,000 or greater.

Deadline

- Contributions may be made to a Roth IRA for a current tax year up until the tax filing deadline for that year (generally April 15 of the following tax year), excluding extensions.

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2. Convert pre-tax amounts from a traditional IRA or qualified plan.

- Amounts in a traditional IRA or qualified plan may be converted by rolling those amounts to a Roth IRA, regardless of MAGI or age.
- Any taxable amounts rolled over from a traditional IRA will be includable in income in the year distributed.
- After-tax contributions in a traditional IRA may not simply be rolled over to a Roth IRA. Distributions from IRAs are taxed under a pro rata or "cream in the coffee" rule. Once after-tax money (the cream) has been combined with before-tax money (the coffee) in an IRA, every drink (that is, distribution) taken from the plan will be considered part "coffee" and part "cream". For this purpose, all traditional IRAs are aggregated.
- If there are after-tax contributions in a qualified plan, new rules will generally allow the after-tax contributions to be rolled over tax-free to a Roth IRA, assuming all of the money in the plan is withdrawn. The pro rata rule continues to apply to partial withdrawals.

Deadline

- There is no extended deadline for conversions. To be reportable as taxable in a given year, conversions must be initiated prior to December 31 of that year.

Planning Point: Roth Opportunity after Tax Reform

Roth IRAs may make even more sense now after tax reform enacted in 2017

Roth IRAs are generally suggested if taxpayers believe taxes will be higher when distributions will be made than when contributions are made. Under the Tax Cuts and Jobs Act, individual tax rates have been reduced and income thresholds have been modified. These lower rates are scheduled to expire or sunset at the end of 2025 and revert to the higher 2017 rates in 2026.

With income taxes temporarily reduced, it may make sense to contribute to Roth IRAs and Roth 401(k) accounts to the extent possible. It may even make sense for IRA owners in general to convert amounts held in traditional IRAs each year to the extent they can do so in lower income tax brackets. IRA owners who expect that they and their beneficiaries will always be in a very high tax bracket way want to convert their entire IRA as quickly as they can. Of course, consideration has to be given to the effect of any conversion and increased AGI on the applicable capital gains tax rate, the taxation of Social Security benefits and any increase in Medicare premiums.

Roth IRA Distributions: Two-Fold Treatment

The taxation of any withdrawal from a Roth IRA depends on whether the withdrawal is qualified and, if it's not, whether the withdrawal amount is from regular contributions, conversion amounts or earnings. Generally, withdrawals of regular contributions to a Roth IRA are not taxable.

Qualified Distributions

To be a *qualified* distribution from a Roth IRA, it must satisfy two requirements — a holding period and a triggering event.

- First, an initial contribution must have been made to any Roth IRA five tax years before the withdrawal occurs.
- Second, the distribution must satisfy one of four triggering events — turning age 59½, death, disability or a qualified first-time home purchase.

Nonqualified Distributions

A *nonqualified* distribution is defined as any withdrawal that is not qualified. Nonqualified distributions from Roth IRAs are treated as made in the following order:

- The first withdrawals are made from regular contributions to the Roth IRA, and these regular contributions can be withdrawn tax- and penalty-free at any time.
- Once regular contribution amounts are exhausted, withdrawals are made from conversion contributions from a traditional IRA or 401(k) plan. If any conversion contributions were made, these are calculated on a first-in first-out, or FIFO, basis — the distribution is treated as coming from the first converted amount that was includable in income, and then from the nontaxable part, if any, of that converted amount.
- Finally any other withdrawals made are considered to be from earnings on the regular Roth IRA contributions and conversions.

Similar to traditional IRAs, all of an individual's Roth IRAs must be aggregated for purposes of applying the ordering rules.

Early Distribution Penalty

- Unless an exception applies, nonqualified distributions from Roth IRAs made before age 59½ are subject to the 10 percent early distribution penalty to the extent that the distribution is includable in income.
- The 10 percent early distribution penality may also apply in the case of a nonqualified distribution attributed to an earlier conversion within the past five years — even if the current distribution itself is not taxable.

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Life Insurance: A Tax-Advantaged Alternative

While not a qualified account like a Roth IRA, single premium life insurance also receives some tax advantages under the Internal Revenue Code.

- Life insurance policies accumulate cash value on a tax deferred basis — if cash value exceeds premiums paid, it is generally not a currently taxable event.
- Life insurance death benefits are paid to the insured's beneficiary income tax-free.
- Single premium life insurance is a tax-efficient wealth transfer tool:
  - It immediately leverages a single premium into a larger tax-free death benefit
  - The tax-free death benefit may also be used to help beneficiaries of IRAs and qualified plans pay income taxes on conversions of such benefits to Roth IRAs, serving as an additional source of future tax-free income

Additional advantages of a permanent life insurance policy include:

- Contribution limits are determined by underwriting and not the Internal Revenue Code
- Accelerated Death Benefit in the case of chronic illness or terminal illness
- Depending on state of residence, policy design and personal circumstances, life insurance may provide additional protection from creditors
- Death benefit proceeds transfer by contract (per beneficiary designation) and bypass probate

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