Proactive IRA Planning Strategies after Tax Reform

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The tax cuts and Jobs Act (TCJA) affects the retirement, tax, and estate planning for nearly all your clients and their families. Changes in income tax rates, Roth IRA conversions, and the estate tax exemption require you, as a planner, to fully understand the complex new tax rules relating to IRAs.

What proactive IRA strategies and practical planning opportunities can you employ to help your clients maximize their tax efficiency and retirement income? Assess the following considerations in the context of your clients' estate planning intentions.

Funding Roth IRA Conversions

TCJA makes converting assets held in a traditional IRA, as well as similar types of tax-deductible accounts, to a Roth IRA more beneficial, because doing so creates retirement accounts that are free from future income taxes. The caveat is that converting to a Roth IRA raises income for that year, resulting in an upfront tax bill. Consequently, new tax breaks that exist at lower income levels, such as the 20 percent qualified business income (QBI) deduction for a pass-through business, might lose value as your clients' income increases.

In contrast, converting at a lower rate now may assure many of your clients will pay less tax than in the future, when the possibility of higher tax rates means more tax will be paid on IRA distributions. Run projections to ensure a Roth IRA conversion will provide an overall economic benefit. Clients who can pay the income tax now on the Roth IRA conversion from non-IRA funds may greatly benefit by enjoying higher investment returns from the Roth IRA "tax-free" asset class.

Most importantly, there are no required minimum distributions (RMDs) from a Roth IRA at age 70½. Future withdrawals (after a five-year waiting period) are tax-free for Roth IRA owners who are age 59½ and older. These distributions will not thrust your clients into a higher tax bracket or trigger higher Medicare premiums.

Another notable change resulting from the TCJA is that your clients will no longer be able to unwind a Roth IRA conversion through recharacterization. In collaboration with your clients' qualified tax professionals, you may want to have your clients wait on doing a Roth IRA conversion until year's end, when they have a more accurate snapshot of their income and deductions. Be mindful that Roth IRA contributions can still be recharacterized as a contribution to a traditional IRA, and vice versa, before the filing due date of your clients' tax returns.

Single taxpayers who are under age 70½ and make more than $137,000 in 2019 (or married couples making more than $203,000 in 2019) cannot directly contribute to Roth IRAs, but they can make "backdoor" Roth IRA contributions, a strategy now considered legal with passage of the TCJA. The "backdoor" Roth IRA benefit can be doubled for your clients who are married, filing jointly, and under age 70½, by having their non-working spouse also make non-deductible IRA contributions that are subsequently converted to a Roth under spousal IRA rules. Be wary, though, that these "backdoor" Roth IRA conversions are subject to pro-rata rules, which means that balances of all owned IRAs, including SEP and SIMPLE IRAs, are factored into the pro-rata calculations when determining the tax owed on the conversion.[1]

Estate Planning Opportunities

In addition to delivering tax-free income during retirement years, Roth IRAs are also free of estate and gift taxes for more high net worth clients now that new legislation has doubled the estate, gift, and generation-skipping transfer (GST) tax exemptions to $11.4 million per individual and $22.8 million per couple in 2019. Note that these increases may be temporary, with provisions possibly lapsing after year 2025. In conjunction with the counsel of an estate planning attorney, you can guide your clients in converting IRA assets to Roth IRAs, so that they optimally fund their unified credit bypass trust or GST exemption, if applicable.

The upshot is that your clients can leave more assets to their heirs on an after-tax basis or gift funds to family members without cutting into their lifetime gift tax exemption. Also, it is now easier to gift to family members to pay the tax on a Roth conversion or to fund Roth IRA contributions for younger family members who have earned income.

Consider Roth IRA conversions for your high net worth clients to pass on more Roth IRA funds to grandchildren tax-free and take advantage of the new increased GST exemption. Unlike the estate tax exemption, the GST exemption for large estates is not portable. Your clients can lose the full GST exemption if it is not utilized.

Further, Roth IRA conversions are more advantageous for clients who may now be subject to the new "kiddie" tax rules, which apply to children under age 18 and full-time college students under age 24. The new tax law changes these rules so that children will now have their unearned income—not wages—taxed at trust tax rates, rather than at their parents' tax rate. Understand that the 2019 top trust rate of 37 percent kicks in when taxable income surpasses only $12,750.

A Roth IRA conversion for your clients may eliminate the trust tax on those RMDs when their grandchildren inherit a large IRA held by a trust. Otherwise, RMDs alone on large, inherited IRAs will exceed $12,750 in unearned income and be taxed at the highest trust tax rate if income is retained in the trust. Roth IRAs remove the trust tax predicament, because post-death RMDs from the inherited Roth will be tax-free.

Investment Expenses

The deduction for miscellaneous itemized expenses, including investment expenses, is eliminated by the new tax law. Prior to the TCJA, clients paid their investment management fees out of non-retirement accounts, so they could deduct them.

Determine whether it makes sense for your clients to pay investment advisory fees directly from their IRA or other retirement accounts. Even though clients may compromise future tax-free growth on the IRA money, they will pay these fees with pre-tax dollars, which is favorable from a tax perspective. Expenses paid from clients' IRAs do not count as taxable withdrawals.

Be aware that an IRA must never pay any expenses but its own. Traditional or Roth IRAs cannot pay investment fees for taxable accounts.

Charitable Tax Break

Encourage your clients who are age 70½ and older to direct up to $100,000 per year from their traditional IRA to a qualified charity tax-free to fulfill their annual RMD. This qualified charitable distribution (QCD) strategy, which was made a permanent part of the tax law in late 2015, is more valuable after TCJA because the higher new standard deduction means fewer clients will be itemizing expenses and taking charitable contribution deductions.

Plan ahead and run tax projections for clients who will use QCDs to save money. Donors can give funds to multiple charities with this technique. Be mindful that you cannot obtain a double tax break by taking a QCD and receiving an itemized deduction for a charitable gift.

Unlike itemized charitable deductions, these QCDs lower the amount of modified adjusted gross income subject to taxation and can possibly help your clients avoid Medicare premium increases. Older business owner clients subject to RMDs on their IRAs can benefit from using QCDs to help qualify for the 20 percent business income deduction on their pass-through entity.

Finally, you should tell your clients to notify their qualified tax preparer about their QCDs, because IRA custodians are not required to identify the transaction as QCDs on the annual 1099-R form, and it may be reported as a RMD. ■

Endnote

1. For more on this, see "The IRA Aggregation Rule and Pro-Rata Taxation of After-Tax IRA Dollars," by Michael Kitces, posted on Oct. 14, 2015, at kitces.com.