Proactive IRA Planning Strategies After Tax Reform

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The Lubitz Financial Group

PERSONAL FINANCIAL PLANNING & INVESTMENT MANAGEMENT

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Tax Cuts and Jobs Act of 2017 Changes

- Reduces personal marginal tax rates for most households
- Lowers corporate tax rates
- Increases estate tax exemption
- Nearly doubles standard deductions
- Eliminates personal exemptions
- Eliminates itemized deductions except for state/local income taxes & property taxes (capped at $10,000), mortgage interest, charitable deductions, and medical expenses (subject to income threshold)

Ordinary Income Tax Rates for 2018

Marginal Tax Rate	Married Filing Jointly	Single
10%	$0 – $19,050	$0 – $9,525
12%	$19,051 – $77,400	$9,526 – $38,700
22%	$77,401 – $165,000	$38,701 – $82,500
24%	$165,001 – $315,000	$82,501 – $157,500
32%	$315,001 – $400,000	$157,501 – $200,000
35%	$400,001 – $600,000	$200,001 – $500,000
37%*	Over $600,000	Over $500,000

*The top tax is effectively 40.8% for those subject to the Medicare surtax on net investment income.

IRA Income Tax Treatment Refresher

	Traditional IRA	Roth IRA	Non-Deductible IRA
Tax Deduction for Contribution	√		
Tax-free Distributions		√	Contribution returned tax-free
Tax-free Compounding	√	√	√
Required Minimum Distributions	√		√

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Why Roth IRAs?

- No lifetime Required Minimum Distributions (RMD)
  - Enables additional tax-free deferral
- Tax-free withdrawals after a five year waiting period
  - Distributions won't thrust clients into a higher tax bracket or trigger higher Medicare premiums
- Tax diversification

Funding Roth IRA Conversions

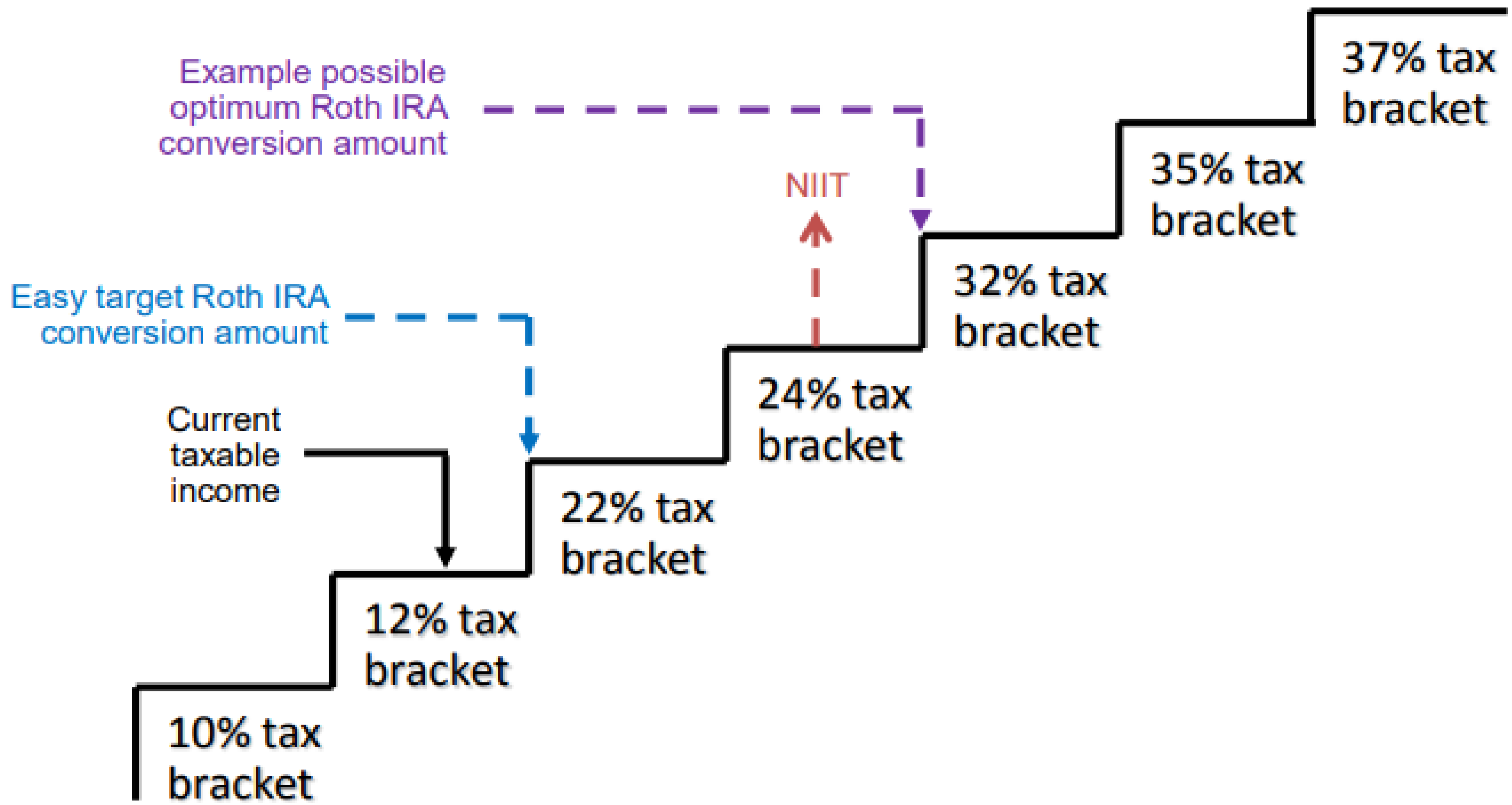
- Converting Traditional IRA to Roth IRA assets at a lower rate now may help clients pay less tax than in the future.
  - **Caveat:** <u>Pretax portion of conversion is added to client's income in year of conversion.</u> New tax breaks that exist at lower income levels, such as the 20% Qualified Business Income deduction for a pass-through business, may lose value as income increases.

- Anyone with an eligible distributing account can convert!
  - No minimum or maximum income
  - No minimum or maximum age
  - No filing status restrictions

5 Reasons to Convert to Roth IRA

- Tax rate arbitrage
- Increase tax-free savings by paying conversion tax with non-IRA funds.
- Client is young and will not need the conversion amount for retirement. Funds are enabled to grow over long-time horizon.
- No RMDs prevent draining of IRA or qualified account and increase tax planning flexibility
- Favorable tax treatment for surviving spouse, as compressed single tax rates will not apply to RMDs.

Roth IRA Planning – Tax Rate Arbitrage



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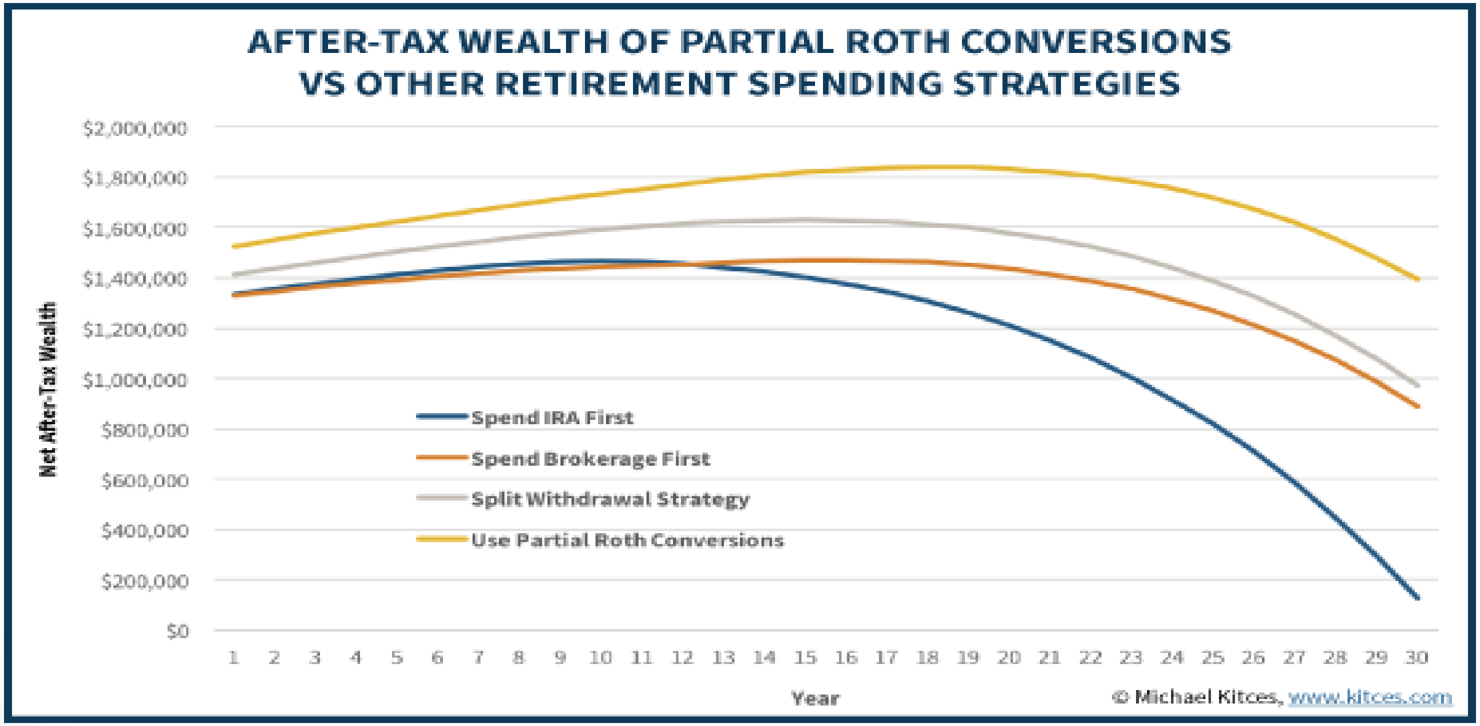
Tax Efficiency with Roth Conversions

- Taking advantage of filling lower tax brackets plus additional tax-favored compounding in Traditional and Roth IRA accounts means partial Roth conversions yields greater (after-tax) wealth compared to other retirement spending strategies.



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Timing Roth IRA Conversions

- Shifting some or all of traditional IRA or qualified plan assets to Roth accounts over time could control the taxable income clients recognize in any one year.

- Be aware of transactions, such as the sale of highly appreciated assets or a large Roth IRA Conversion, that may increase overall income above $200,000 ($250,000 for couples) Modified Adjusted Gross Income (MAGI) threshold for 3.8% Net Investment Income Tax.

- Roth IRA conversion income will count toward MAGI.

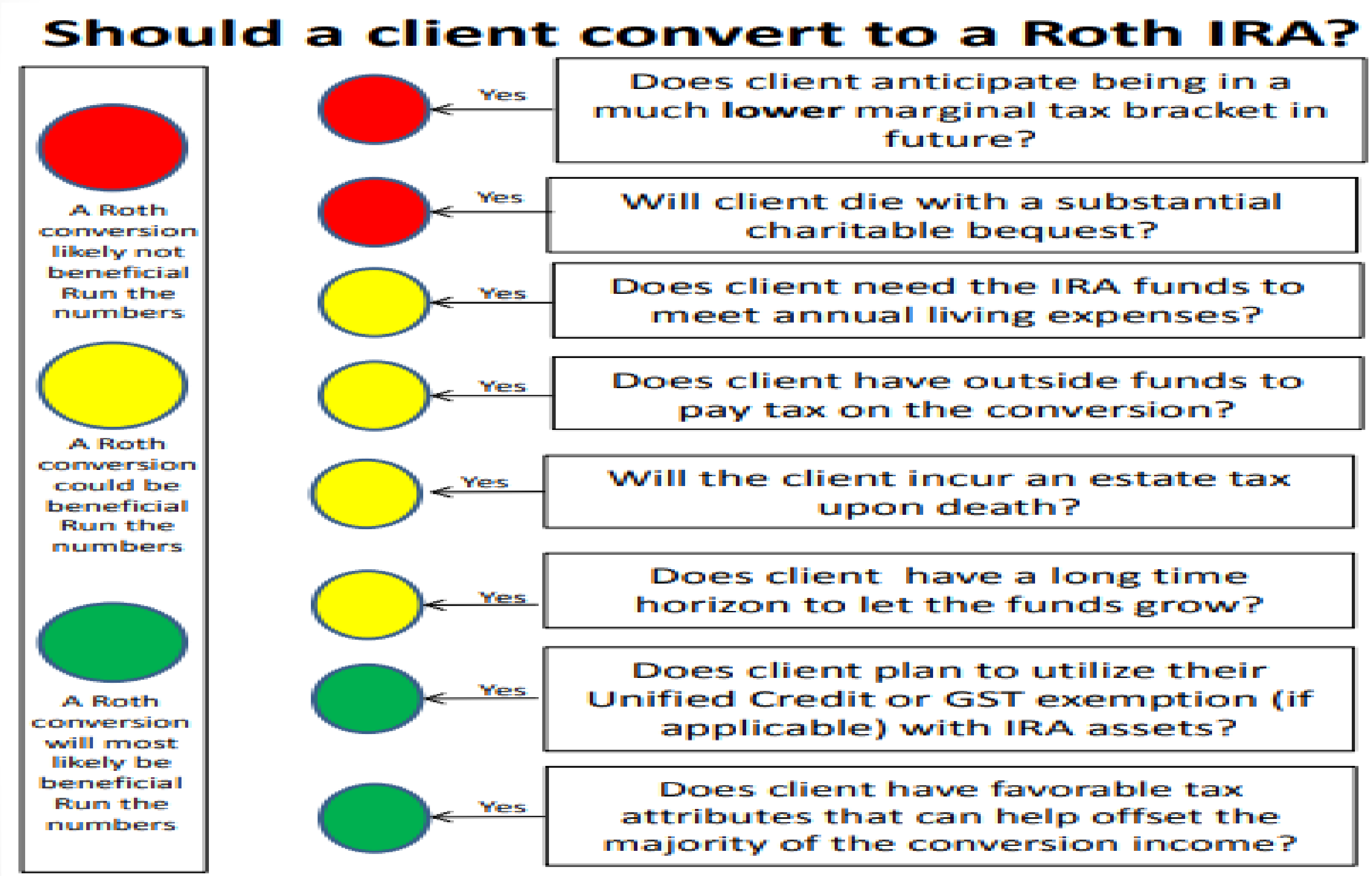
- Roth IRA distributions are not included in net investment income. Withdrawals from Roth and Roth 401k plans are also excluded from MAGI.

Reducing 3.8% Surtax with Roth IRA Conversion

- This strategy can be worthwhile for clients who expect income to rise above MAGI thresholds in retirement years when they will be taking Social Security and qualified plan withdrawals.
  - Roth IRA recharacterization rules are repealed after 2017.

- Do projections to make sure Roth IRA Conversion provides an overall economic benefit.

Should Clients Convert to Roth IRAs?



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Roth IRA Recharacterizations

- Roth **recharacterization** cannot be used to unwind a Roth conversion in 2018 and later years.
    - Strategy: Wait on converting Roth IRA until year's end, when you have a more accurate picture of clients' income and deductions.

- Roth IRA contributions can still be recharacterized as a contribution to a Traditional IRA, and vice versa, before the filing due date of the clients' tax returns.

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Backdoor Roth IRA Conversions

- **Backdoor Roth Strategy:** <u>When income is too high to make a Roth IRA contribution, you can contribute to a non-deductible traditional IRA and then convert those funds to a Roth IRA.</u>
  - Funds that end up in the Roth IRA through a back-door conversion are **converted** funds, **NOT** Roth IRA contributions.

Phase-out limits for 2018 Roth IRA contributions

Single	$120,000 to $135,000
Married–Joint	$189,000 to $199,000
Married–Separate	$ to $ 10,000

- **Caveat:** Pro-rata rules apply to backdoor Roth IRA conversions
  - 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.

Backdoor Roth IRA Pop Quiz

- **Example 1** – Bob, 73, and Jan, 72, collect $210,000 of taxable income during 2018 year from work income, Social Security benefits, and brokerage investments. *Can they contribute to Roth IRA for 2018 tax year through a back door conversion?*

- **Example 2** – Betsy, 46, earns $300,000 in wages and makes an employee deferral of $18,500 to her 401k in 2018. She has not made any additional 2018 year contributions to retirement accounts. There has been no investment activity in her SEP IRA with $70,000 balance and a former employer's 401k with $140,000 balance. *Would she owe taxes on contributing $5,500 to a Roth IRA through a backdoor conversion?*

“Mega-Backdoor” Roth Conversion

- Employees can possibly convert much larger (“Mega”) sums to a Roth IRA while minimizing tax consequences.
  - Strategy is an option for those with significant resources and income who have already maxed out contributions to other retirement accounts.

- Contribution limits are significantly higher – starting above $18,500 pre-tax maximum (or $24,500 if age 50 & older) - and extending all the way up to $55,000 limit for pre-tax, after-tax and employer contributions (or $61,000 if age 50 & older).
  - Employees can withdraw just their after-tax money, pay income tax on the earnings, and convert the withdrawal to a Roth IRA.

- 401k plan must allow for non-Roth, after-tax contributions.

Estate Tax Changes

- Doubles the basic estate, gift, and Generation Skipping Transfer (GST) tax exemption to \$11.18 million in 2018.
  - Roth IRA conversions can reduce the size of taxable estate.

- Portability rules remain unchanged, meaning married couples may transfer \$22.36 million at death with no estate tax.
  - Unused estate and gift tax exemption is **portable** to surviving spouse. Unused exemption for GST tax is **NOT portable.**

- Step-up in basis at death remains intact for qualifying estate assets (but not for IRAs).

Expanded Gift Tax Exemption Planning

- **Clients can give up to $15,000 a year in 2018 to as many people as they wish, totally free of any gift tax.**

- Upshot: Clients are able to 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.
  - Gifts for Grandchildren – to use GST exemption (fund Roth IRA contributions for young family members, who have earned income)
  - Gifts for Roth IRA Conversions – to pay income tax on Roth conversions and to optimally fund their Unified Credit Bypass Trust
  - Gifts for life insurance
  - Gifts to irrevocable trusts and charitable trusts
  - Gifts of business interests for succession planning and estate reduction

Kiddie Tax

- Roth IRA conversions may be more advantageous for clients who are subject to the new “kiddie” tax rules
  - Apply to 2018 tax year unearned income greater than $2,100 of a dependent child under age 18 (in some cases, under age 19) or full-time college student under age 24.

- New tax law changes these rules, so that children have their unearned income, not wages, taxed at trust tax rates.
  - Child’s tax on unearned income may be either higher or lower than parents’ rate.

- Before 2018, this tax applied at the tax rate of child’s parents.
  - Kiddie tax can exceed parents’ rate for families of modest means.

Trust Tax Rate Predicament

- **Trust Tax Problem:** 37% tax rate kicks in when trust taxable income surpasses only $12,500 in 2018 year.
  - 37% tax rate kicks in when taxable income exceeds $500,000 for single filers and $600,000 for married couples filing jointly.

Trust Tax Rates for 2018

Trust Income	Tax Rate
$0 – $2,550	10%
$2,551 – $9,150	24%
$9,151 – $12,500	35%
Over $12,500	37%

Roth Conversion Benefit for IRA Trusts

- Roth IRA conversions for your clients may eliminate the trust tax on those Required Minimum Distributions (RMDs) when their grandchildren inherit a large IRA held by a trust.

- RMDs alone on large inherited IRAs will exceed $12,500 in unearned income and be taxed at the highest trust tax rate if income is retained in the trust.
  - IRA distributions are **unearned** income.

- Post-death RMDs from the inherited Roth will be tax-free.

Kiddie Tax Pop Quiz

- **Example 1** – Mary, age 15, has a custodial UTMA account with $100,000 of taxable bond investments earning 4% interest. Her parents, who reside in Florida, are in the 22% marginal federal tax bracket. *What is her 2018 year kiddie tax rate?*

- **Example 2** – Paul, age 11, has a custodial UTMA account with $100,000 in low basis stocks and mutual funds. He receives $2,500 in qualified dividends and $2,000 in long-term capital gain distributions. *What is his 2018 year kiddie tax rate?*

Qualified Charitable Distributions

- IRA owners and beneficiaries who are actually **age 70 ½ and older** can direct up to $100,000 per year from their IRA to a qualified charity tax-free to fulfill all or a portion of their annual required minimum distribution.
  - **Qualified Charitable Distributions (QCDs)** are not tax-deductible. Donor can give funds to multiple charities.

- This charitable contribution lowers amount of income subject to taxation and can possibly reduce Medicare premiums.
  - 2018: More income subject to higher Medicare surcharges

Charitable Tax Break

- Qualified Charitable Distributions (QCDs) strategy is more valuable after new tax law because the higher new standard deduction means fewer clients will be itemizing expenses and taking deductions for charity.
  - Must be direct gifts from IRA to charity or via check payable from IRA to the charity.
  - Can only be made from the taxable portion of IRAs, Roth IRAs, and inactive SEP and SIMPLE IRAs

- <u>QCDs can actually add to the standard deduction. In effect, clients get the standard deduction plus charitable deduction.</u>

Saving Taxes with QCDs for Single Filer

	Not Using a QCD	Using a QCD
2018 Income without IRA Activity	$205,000	$205,000
2018 IRA Req. Min. Distribution (RMD)	$10,000	
Adjusted Gross Income	**$215,000**	**$205,000**
Medical Deductions	$3,000	$3,000
*Charity	$10,000	$0
Total Deductions	$13,000	$3,000
New Standard Deduction	**$13,600**	**$13,600**
Taxable Income	**$201,400**	**$191,400**
Taxable Income Difference		$10,000
Tax rate		35%
Tax Savings		**$3,500**

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Comparing Tax Efficiency of QCDs and Donating Appreciated Stock

	QCDs	Appreciated Stock
AGI effect	Reduces AGI *and* taxable income – reduces stealth taxes	Reduces only taxable income
Age limit	Older demographic – only available to those IRA owners or beneficiaries who are age 70 ½ or older	None
Step-up in basis	Preserves step-up in basis	Step-up in basis is lost
Limitations	Limit $100,000 per person, per year	Limited to 30% of AGI New tax law limit for cash contributions has increased from 50% to 60% of AGI

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Investment Expenses Planning

- Fees are no longer deductible as an itemized deduction
  - Prior to new tax law, clients could pay investment advisory fees from their non-retirement accounts, so they could deduct them.

- **Plan Ahead:** Does it make sense for clients to pay investment fees directly from their IRA or other retirement accounts?
  - Even though clients may compromise future tax-free growth on IRA money, they will pay these fees with pre-tax dollars, which is favorable from a tax perspective.
  - Expenses paid from IRAs do not count as taxable withdrawals.

- An IRA must never pay any expenses but its own. Traditional or Roth IRAs cannot pay investment fees for taxable accounts.

Alimony Strategy with IRAs

- **Alimony Agreements <u>After</u> December 31st, 2018:**
  - Alimony paid is not deductible & alimony received is not taxable.
  - Existing agreements are grandfathered

- **Strategy After 2018**: Consider utilizing IRAs or 401ks in place of alimony to gain deduction, since these are pre-tax funds.
  - Alimony recipient must pay income taxes on the IRA distributions, but likely at a lower tax rate.

- Existing alimony agreements can be modified, including existing pre-nuptial agreements that were made based on prior tax law, permitting alimony deduction.

Questions? Please Contact Me. Thank You.

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