Summit Financial Resources, Inc.
Planning Alert

Surprising Facts of Roth IRAs

1. You are never too old to contribute. If you have earned income and your modified adjusted gross income is below an annually adjusted threshold ($135,000 for single filers and $199,000 for married filing jointly for 2018)[(1)], you can contribute to a Roth IRA. Your age does not matter. This often comes as a surprise to taxpayers because you cannot contribute to a traditional IRA once you reach the year you turn 70 ½. Roth IRAs are different. Age is never a barrier to making tax year contributions.

2. Your participation in an employer plan does not prevent you from making a Roth IRA contribution. Do you have a 401(k) at work? If you are concerned that participation in your employer plan makes you ineligible to contribute to a Roth IRA, don't be! You can max out both. But what if your employer plan is Roth 401(k) plan? No worries! You can fully fund a Roth 401(k) and a Roth IRA for the same year.

3. Almost anyone with a traditional IRA can convert it to a Roth IRA. There used to be restrictions on conversions due to income limits or tax filing status. These restrictions went away back in 2010, opening the door to conversion for almost any taxpayer who owns a traditional IRA. The only exception would be of an inherited traditional IRA (other than the spouse of the deceased owner). Unfortunately, conversion is not available for those beneficiaries. If you haven't converted, this might be the year for you to make that move. You will want to discuss your situation with a knowledgeable tax or financial advisor. Just because everyone with a traditional IRA can convert, does not mean that they should. Conversion is not one size fits all.

4. You can always access your contributions tax and penalty free. Are you avoiding contributing to a Roth IRA because you are worried you might need that money? Don't let this fear stop you from making that Roth IRA contribution. Your tax year Roth IRA contributions are always available to you tax and penalty free regardless of your age and what you intend to do with the money. More good news is that the rules for Roth IRA distributions are very taxpayer friendly. Your contributions are not only always accessible tax and penalty free, they are also considered to be the first money distributed from your Roth IRA.

5. You don't ever have to take distributions from your Roth IRA, but your beneficiaries do. During your lifetime, distributions are never required from your Roth IRA. Roth IRAs are not subject to the required minimum distribution (RMD) rules that apply to traditional IRAs while you are alive. Your money can grow tax-free for your entire lifetime. Your beneficiaries will have to take RMDs from the inherited Roth IRA. That is the bad news. However, the good news is that these distributions will almost always be tax and penalty free.

Roth IRAs - Even More Valuable Today

The Tax Cuts and Jobs Act has made Roth IRAs and conversions to a Roth IRA more valuable with the lower tax rates that most clients will fall under, especially if outside funds are used to pay the tax and with the expectation of higher tax rates in the future.

Old Law		New Law [(1)]	
Tax Rates	Income	Tax Rates	Income
10.0%	up to $18,650	10.0%	up to $19,050
15.0%	$18,651-$75,900	12.0%	$19,051-$77,400
25.0%	$75,901-$153,100	22.0%	$77,401-$165,000
28.0%	$153,101-$233,350	24.0%	$165,001-$315,000
33.0%	$233,351-$416,700	32.0%	$315,001-$400,000
35.0%	$416,701-$470,000	35.0%	$400,001-$600,000
39.6%	over $470,000	37.0%	over $600,000

These new tax rates are in effect through 2025 so consider making smaller annual conversions if a client does not like paying a large tax in one year. Conversions are not subject to the Net Income Investment Tax (3.8%) either though it could trigger other income to be subject to the tax.

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Strategy #1: Mega Backdoor Roth IRA

Make the maximum contribution to a 401(k) plan. For 2018, the maximum contribution is $55,000 ($61,000 with a 'catch-up' contribution) [1]. Beyond the maximum tax deductible contribution ($18,500 or $24,500 if over age 50) [1], if allowed by the plan, you can make 'after-tax' contributions of up to $36,500 (any company match would reduce this amount). The following year, you can withdraw the "after-tax" contribution amount to a traditional IRA if your employer allows in-service non-hardship withdrawals. Once the money is in a traditional IRA, convert into a Roth IRA.

Strategy #2: Backdoor Roth IRA

You can do this same strategy on a smaller scale by contributing to a non-deductible IRA. Individuals prohibited from depositing directly into a Roth IRA can deposit the maximum amount permitted ($5,500 under age 50 and $6,500 over age 50 for 2018) [1] to a non-deductible IRA, the backdoor Roth IRA is completed by immediately converting the non-deductible IRA into a tax-free Roth IRA. This strategy will work better if the client does not have any existing traditional IRAs to avoid the pro-rata rule.

Strategy #3: Consider recharacterizing Roth conversions from 2017

Another tax rate arbitrage opportunity. If the client does not have a large gain from a conversion, consider recharacterizing a recently done Roth conversion and then subsequently convert in 2018 at a presumably lower tax rate. Review all clients that you made a 2017 Roth conversion for to see if it makes economic sense. A Roth IRA conversion made in 2017 may be recharacterized as a contribution to a traditional IRA if the recharacterization is made by October 15, 2018. A Roth IRA conversion made on or after January 1, 2018, cannot be recharacterized.

Advantages to Converting
* Lower Tax Rates
* Not subject to 3.8% net investment tax
* Could save considerable money in taxes in the long run
* Contributions could be withdrawn tax & penalty free

Disadvantages to Converting
* Upfront tax bill
* Conversion could push you into a higher tax bracket
* Conversion could trigger other income subject to the 3.8% net investment tax
* Recharacterization of prior conversions has been eliminated as of 10/15/18

[1] Source: www.irs.gov

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