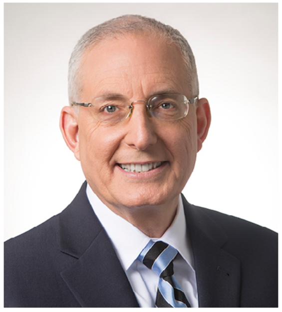

ED SLOTT'S

IRA ADVISOR

Tax & Estate Planning for Your Retirement Savings

April 2022

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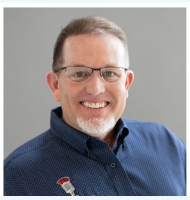
Unconventional IRA Planning

Guest IRA Experts



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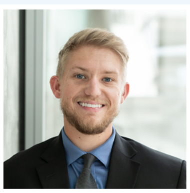

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April, when taxes are on people's minds, can be an excellent time to focus on "rest-of-year" planning for IRAs and employer-sponsored retirement accounts. During such consideration, going beyond the usual strategies may significantly enhance a senior's lifestyle after the paychecks stop. Here are some beyond-the-box thoughts.

Weigh In-Service Withdrawals

We have encouraged using the "in-service withdrawal option" for years. Even so, it continues to be mind-blowing how many seniors, 60 and older, have no idea this choice is available to them. In fact, most people have never heard about this tactic.

Approximately 95% of 401(k) and other employer-sponsored retirement plans allow participants to take distributions of vested funds while they're still employed, once they reach age 59½. The money can be withdrawn — *subject to income tax but not subject to the 10% early distribution tax* — or moved to another retirement account, such as an IRA, maintaining the tax deferral.

Why would plan participants take in-service withdrawals? Mainly for increased flexibility with their retirement funds. Employer plans generally have limited menus from which employees choose how their money will be invested.

Once people reach age 59½, they typically should place more emphasis on risk control. A large drop in their retirement account due to market weakness can be devastating.

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At this stage of life, there is less time left to recover from broad market pullbacks. The bear markets of 2000-2002 and 2007-2009 were extremely harsh on people who retired around those years.

After an in-service withdrawal, seniors can use the withdrawn dollars to set up their overall portfolios for risk reduction. Possibilities include fixed income options that provide protection from market fluctuation and contractual income options that come with certain annuities from insurance companies. The key is to tailor an age 60+ retirement portfolio to match each individual's circumstances and prospects.

What's more, money building up within tax-deferred retirement accounts will have to come out eventually, either for living expenses or for required distributions after age 72. Withdrawing (and paying tax on) some money now may help to reduce future taxes at steep tax rates.

Thus, one possible approach is to use an in-service withdrawal to transfer money from an employer plan to an IRA, followed by a withdrawal for needed cash. The withdrawal can be fine-tuned to remain in a favorable tax bracket.

By using an IRA in this way, not only is the pre-age-59½ 10% tax avoided, there also is no mandatory 20% tax withholding on IRA distributions, as there would be with withdrawals from qualified employer-sponsored plans. All the withdrawn funds will be accessible right away.

Meanwhile, employees maintain their participation in their employer plan after an in-service withdrawal, even if all the money comes out. They will be able to continue contributing earned income to the plan and receive any employer match that's offered.

Another benefit of rolling over all or a portion of a tax-deferred company plan to an IRA after the age of 59½ is the option to convert some or all of those tax-deferred dollars to a Roth IRA. (More on this below). This would allow the account owner to move forever-taxed dollars to never-taxed dollars.

If the senior planned to work until age 65, this would give him or her the opportunity to pay the tax now (at age 59½) and have those investments grow tax-free for several years. Then the money could be removed tax-free during retirement, when tax planning is critically important. Distributions from a Roth account or a cash value life insurance account will not be included in taxable income and will not affect the taxation of Social Security distributions or the amount of Medicare premiums.

Include Life Insurance

What might be done with cash that comes out via an in-service withdrawal to an IRA, free of the 10% early distribution tax and the 20% mandatory withholding? One option is to use the money on life insurance. At age 59½, many people are healthy enough to get coverage at a reasonable cost.

With a likelihood of higher future tax rates and the increased health care costs that higher longevity might bring, life insurance can play a vital role in estate planning. One of the greatest benefits in the tax code is the tax-free exemption for life insurance proceeds, which can insure substantial cash for beneficiaries, even if the insured individual's other assets are depleted. (A life insurance policy can't be held in an IRA but the after-tax proceeds from IRA distributions can pay the premiums.)

One of the greatest benefits in the tax code is the tax-free exemption for life insurance proceeds.

Downgrade IRA Deductions

People who are eligible to deduct contributions to traditional IRAs may prize upfront tax savings. However, our experience indicates that a deductible traditional IRA works best for someone who needs a tax deduction.

That need might result from inheriting income-producing property; reporting higher-than-expected income; divorce; death of a spouse; or any change in filing status resulting in a higher tax bracket. Unless people have a specific need for an immediate tax deduction, we encourage them to take advantage of the available Roth options.

Why put after-tax dollars into a Roth account rather than into a tax-deductible traditional IRA? In reality, a tax-deductible IRA contribution does not always produce tax savings. The current tax is merely postponed, with an outstanding bill that may come due when money is withdrawn in retirement, at whatever tax rate Uncle Sam will impose at that time.

Thus, tax-deferred money belongs to the IRA owner only partially. The co-owner is Uncle Sam, who makes the rules on how much of that money belongs to him, and he can change the amounts at any time.

We believe that Uncle Sam is not going to ask for less money in the future. He's broke! Our national debt has reached 30 trillion dollars, inflation is soaring, and we think taxes are certain to increase. This not-so-rich-anymore Uncle probably will continue to ask for a larger share of distributions from pre-tax retirement accounts.

Moreover, anyone who has not started contributing to an employer-sponsored retirement plan in 2022 should begin now, to take advantage of that opportunity. Check to see if a Roth 401(k) option is available. As explained, it's always better to build tax-free accounts that are owned 100%, with Uncle Sam excluded from future retirement distributions.

Canny Conversions

Roth 401(k) options in an employer's retirement plan are especially attractive because the maximum contribution amounts are available to high-income participants. That's not the case with Roth IRAs. For 2022, single taxpayers must have less than $129,000 of income for a full $6,000 ($7,000 if 50 older) Roth IRA contribution; couples filing jointly must have income under $204,000. Partial Roth IRA contributions are permitted with incomes up to $144,000 and $214,000, respectively.

Therefore, high-income taxpayers might not be able to make a full Roth IRA contribution, or any Roth IRA contribution at all. Fortunately, taxpayers eligible for IRA contributions can contribute $6,000 or $7,000 to a traditional IRA, with no income limits, even if they can't take a deduction.

Subsequently, nondeductible money in a traditional IRA can be converted (a "backdoor contribution") to a Roth IRA, with no income limits. If there is no other money in a traditional IRA, the conversion will be tax-free!

Mini-Roth Maneuvering

A non-deductible traditional IRA contribution, followed by a Roth IRA conversion, can be a prime strategy for high-income taxpayers, allowing them to get money into IRA territory and then converting to a potentially tax-free Roth.

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We frequently come across taxpayers who decide to follow this strategy.

Essentially, this type of backdoor Roth IRA contribution can be considered a mini-Roth conversion of up to $6,000 or $7,000. While developing the plan described above, we also look at the account owner's total traditional IRA holdings and often suggest further mini or partial Roth IRA conversions, if larger amounts can be moved while remaining in a moderate tax bracket.

This strategy ("using many-mini-Roth IRA conversions") can be implemented each year, up to the IRA owner's expected retirement date. The key is to use non-qualified assets held in a separate taxable account to pay the tax due on the Roth IRA conversion, rather than taking funds from the converted account itself to pay the tax. Once money is moved to the Roth side, it is better to keep it there, where it can be invested for long-term, possibly tax-free cash flow in retirement.

Note that this many-mini-Roth conversion strategy provides yet another reason to avoid tax-deductible contributions to a traditional IRA. The more pre-tax money flowing into traditional IRAs, the more tax that will be owed when converting never-taxed IRA dollars to a Roth IRA. ■

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