LITTLE KNOWN SECRETS OF ROTH IRAs – HARNESSING TRULY TAX FREE GROWTH

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Roth IRA investments have been prevalent for many years as one of the most popular retirement strategies available. The major advantage a Roth IRA has over other retirement strategies is that an investor's capital is allowed to grow truly tax free. While the basic premise of this advantage is largely understood, there are a wealth of additional ways in which this type of strategy may be employed in order to maximize a family's long-term benefit.

Sound wealth management is rooted in a standard of care incorporating tax planning, estate planning, risk management, and investment management. The following white paper provides a roadmap for successful navigation of some of the winding but lucrative roads each investor may travel in order to effectively utilize a No-Tax Roth IRA.

Retirees face the challenge of replacing their working income with a combination of pension and Social Security income combined with the cash-flow derived from their various other investments. At Dashboard Wealth Advisors, our team of professionals break assets down into three basic categories: **Pre-Tax**, **Post-Tax**, and **No-Tax**.

Pre-Tax Assets

Consist of all Traditional IRAs, Traditional 401(k)s, SEP-IRAs, and all other vehicles that require the payment of ordinary income tax upon their distribution.

Post-Tax Assets

Consist of all investment accounts that contain after-tax contributions and require the payment of capital gains taxes on earnings, combined with interest and dividend tax payments where applicable.

No-Tax Assets

As the name implies, require absolutely no tax payments upon distribution for the lifetime of the account owner, and oftentimes their direct heirs. These accounts consist of both Roth IRA and Roth 401(k) assets.

"The power of truly tax-free (not tax-deferred) growth can be staggering."

NEW TAX LAW: THE POWER OF $315,000

Unquestionably, the biggest change in the personal tax rates applies to those married individuals making less than $315,000. In 2017, married couples making $75,900 to $153,100 paid tax at the 25% level, then at 28% on income up to $233,450, and then at 33% all the way up to $416,700. Now, the new tax rate reductions have provided an **INCREDIBLE** opportunity for married couples in 2018 and beyond. In 2018, married couples making $77,400 to $165,000 pay tax at the 22% level, and then at 24% on income up to $315,000. **THIS IS A HUGE REDUCTION**. As such, we **STRONGLY ENCOURAGE** these families to consider Roth conversions to take full advantage of these lower rates and strive to convert IRA's to Roth IRA's in order to fully "fill up" all income through $315,000. One never knows how long these tax laws will remain in effect, and this new rate is very attractive.

NEW TAX LAW: ROTH 401K MAGIC

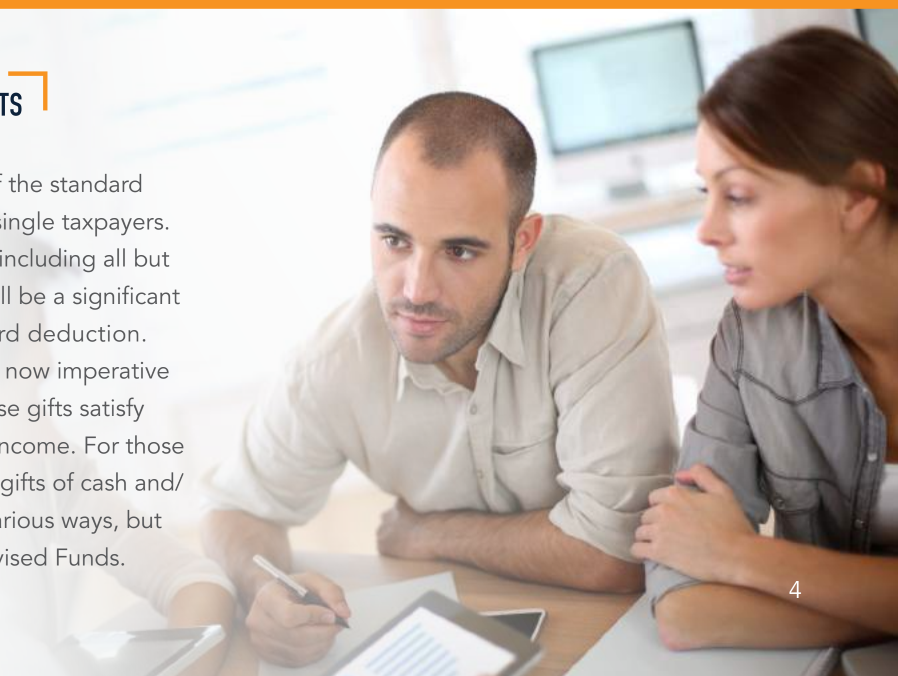
With the significantly lower tax brackets starting in 2018, we encourage nearly everyone in the 24% tax bracket and lower (Married up to $315,000 of income and Single up to $157,500) to **STRONGLY** consider Roth 401k's. However, here is where many make a BIG mistake - they simply sign up to have their salary deductions contributed directly into the Roth 401k. By doing so, all Federal and State taxes are paid first, then the remaining amount is used to fund Roth 401k's. We **STRONGLY** encourage clients to continue to have their salary deductions happen on a traditional 401k basis. This occurs before any level of taxation. Then, once or twice a year, invoke an "in-plan conversion" from traditional 401k assets to Roth 401k assets. Numerous states (including Illinois) **DO NOT TAX** Roth 401k conversions on a state level. By utilizing this strategy, in Illinois, the savings could amount to $915 ($18,500 X 4.95% state tax rate) every single year. Please make sure to check with your 401k administrator to see if "in-plan conversions" are allowed.

EXAMPLE

Bill and Julie Wilson are 67 years old and recently retired. Bill has a small pension from work of $32,000 and both are receiving social security for a total of approximately $46,000. They have $2.4 million in after-tax assets and IRA assets of approximately $1.2 million. Their lifestyle costs approximate $100,000 and as such, they are pulling $22,000 per year from their after-tax assets. Bill and Julie don't need to rely on their IRA assets for quite a long time, but will be required to begin taking RMD distributions in 3 years. As their combined income (social security and pension) is approximately $78,000, we would encourage Bill and Julie to perform a Roth Conversion each year of approximately $237,000 ($315,000 - $78,000). The effective tax rate on this conversion would be less than 24%, representing **SIGNIFICANTLY** less effective taxes than in prior years.

NEW TAX LAW: CHARITABLE GIVING DIRECTLY FROM IRA ASSETS

One major change in 2018 tax law was the near doubling of the standard deduction to $24,000 for married couples and $12,000 for single taxpayers. This, combined with the exclusion of numerous deductions including all but $10,000 of state/local/real estate taxes, means that there will be a significant increase in the number of families that opt for the standard deduction. As such, for those over 70.5 that are charitably inclined, it is now imperative to consider gifting directly from IRA assets. Not only do these gifts satisfy one's RMD, but it also eliminates this amount from taxable income. For those under age 70, it may now make sense to "stack" charitable gifts of cash and/or securities for many years into one. This can be done in various ways, but one common and easy way is through the use of Donor Advised Funds.



BUSINESS OWNERS

Business owners stand to potentially gain much from strategic asset movement and targeted investment planning. This concept is based on the fact that high income earners cannot contribute directly to Roth IRAs, but can contribute to traditional IRAs in an after-tax, non-deductible fashion. However, should an individual then convert IRA assets to Roth assets, taxes must be paid on the pre-tax portion as part of the conversion.

The IRS requires the aggregation of all IRAs, but **EXCLUDES** any and all 401(k) accounts when determining any pre-tax amounts in an IRA. Therefore, if a business owner has a large pre-tax IRA balance, and also has a 401(k) available at his or her own company, consider rolling the existing pre-tax IRA into their own company's 401(k) plan. By doing this, the business owner can now contribute the maximum amount to an after-tax non-deductible IRA, and immediately convert it to a Roth IRA annually. As the business owner would then have no other pre-tax amounts in IRAs, this Roth conversion would be entirely exempt from taxation.

"If a business owner has a large **pre-tax IRA balance**, and also has a **401(k)** available at his or her own company, consider rolling the existing pre-tax IRA into their own company's 401(k) plan."

SPOUSE: NON-WORKING SPOUSE ROTH CONVERSION STRATEGY

This concept is based on the fact that high income earners (defined as families whose Adjusted Gross Income is in excess of $189,000 as of 2018) cannot contribute directly to Roth IRAs. These families can, however, contribute to traditional IRAs in an after-tax, non-deductible fashion.

If the case is such that one spouse has either little or no pre-tax funds in IRAs, a family can contribute the maximum allowable IRA contribution and subsequently convert this amount annually to a Roth IRA. If the individual does not have any other pre-tax IRAs, this annual Roth conversion is entirely exempt from federal income taxation.

EXAMPLE

Brantley Foster makes $325,000 per year and his wife Christy does not work. Brantley would put money into an IRA for Christy. They would then convert Christy's IRA to a Roth IRA because doing so is tax-free as long as Christy has no other pretax IRAs.

PARENT-CHILD : "BUYING" A PARENT'S IRA

This Roth IRA approach is based on the idea of a wealthy adult child gifting assets back to his parents in return for the parents converting their own traditional IRA assets into Roth IRA assets.

Once this conversion is done, the primary beneficiary of the Roth IRA assets is changed from the spouse of the parent to either the adult child who gifted the parents the funds or, better yet, the young children of this person. By doing so, the taxes applied to the IRA distributions are at the parent's lower tax bracket rather than the higher tax bracket of the inheriting child.

"The primary beneficiary of the Roth IRA assets is changed from the spouse of the parent to either the adult child who gifted the parents the funds or, better yet, the young children of this person."

PARENT-CHILD: FUNDING ROTH IRAS FOR FUTURE GENERATIONS BY GIFTING MONEY TO PARENTS

Adult children with significant assets often have parents whose asset base isn't as extensive, and may actually be working through their retirement years. If the parents of an adult child are working and earning at least $13,000, annual gifting of $13,000 to the parents should be considered. The parents can then fully fund Roth IRAs ($6,500 per person over age 50), and then name either the adult child or even their grandchildren as primary beneficiary. This in essence shifts $13,000 into tax-free vehicles, reduces the estate of the adult children, and avoids any generation skipping issues.

EXAMPLE

Brantley Foster makes $325,000 per year, placing him firmly in the 35% tax bracket. His father Howard is in retirement, at a 10% tax bracket.

Brantley gifts his father Howard $10,000 cash. Howard then converts $10,000 from his IRA into a Roth IRA and changes the beneficiary from his wife to his son Brantley.

Howard is not necessarily any better off--and certainly no worse off--than before. He merely exchanged $10,000 of IRA assets for $9,000 of cash and used the remaining $1,000 to pay his Federal tax bill. Brantley, on the other hand, exchanged $10,000 of cash for $10,000 of an inherited Roth IRA asset that could possibly have two generations of tax-free growth.

EARLY RETIREMENT: THE "ROTH" RETIREMENT INCOME BRIDGE

Oftentimes, individuals retire before turning 70.5 with significant IRA balances. In these situations, retirees should consider annual Roth conversions designed to fully maximize their current federal tax bracket.

Additionally, in many situations, a sound strategy would be to provide annual living expenses to these families with after-tax assets to help minimize current tax implications while allowing for significant Roth conversions. Knowing that Required Minimum Distributions (RMDs) will be significant, a client can use the period from retirement to attainment of age 70.5 to convert Roth IRA assets at tax brackets either the same or lower than post-RMD years.

EXAMPLE:

Howard just retired at age 60. Howard has a pension of $50,000, $4 million in after tax assets and a $1 million IRA account.

Howard and his wife need $120,000 per year for living expenses. After the $50,000 Howard earns from his pension there is a $70,000 gap to meet the total living expenses amount.

Howard should utilize his after-tax assets to provide his additional cash needs which will help minimize any income tax ramifications. Then, annual Roth conversions of an amount between $115,000 and $265,000 can be executed, designed to move funds from IRAs to tax-free Roth IRAs at a tax bracket no higher than 24%.

By moving the money into Roth IRA accounts, Howard is putting it into a place where it won't be taxed again.

EARLY RETIREMENT: "GIFTING" ROTH IRAS

In situations where the parent's tax bracket is less than the child, consider conversion of Roth IRAs in lieu of (or in addition to) outright gifting. It is important to note, however, that this will not exclude the asset from one's taxable estate. In this scenario, the parent gives the gift of converted Roth IRAs instead of cash, thus paying the tax on the conversion for the child so there's no future taxation on the account.

EARLY RETIREMENT: PLANNED GIFTING

High net worth parents should consider gifting to children up to $24,000 annually and then suggest or require that the kids fully fund their employers' Roth 401(k) of $18,500 (as of 2018), and contribute $5,500 to an outside Roth IRA. This basically removes funds annually from the parent's estate and provides assets to the children in a no-tax environment for two or more generations.

Additionally, for children in their first 5-10 years of their careers, maximizing Roth 401(k) contributions can often be done at a significantly lower tax bracket than the parents.

RETIREMENT INCOME TAXATION: STATE OF MIND

It is vital that one maintains awareness of not only their current state's taxation on Roth conversions, but also the state tax ramifications of one's ultimate retirement destination. Not everyone retires to Florida (coincidentally where there's no state income tax or tax on retirement distributions). Make sure to take into account the state tax ramifications on retirement distributions and plan accordingly.

EXAMPLE:

Mark and Stephanie Rhoades are 54 years old and live in Illinois. They plan on working 8 more years and then retiring to their dream destination just outside of San Diego, CA. Their combined income is $150,000. Mark has a 401k worth $1.3 million and after-tax assets of $450,000. Each year for the next 8 years, Mark and Stephanie should consider converting $165,000 (the top of the 24% tax bracket for married filers of $315,000 minus their income of $150,000) of Mark's 401k to a Roth 401k. Although this would increase their effective tax rate by 2% (from 22% to 24%), they would have converted nearly all of their 401k assets to Roth 401k assets. After Mark and Stephanie retire and move to CA, they would then be able withdraw their Roth 401k assets and avoid ALL California state taxes which could be upwards of 12%.

ROTH 401(K): AFTER-TAX 401(K) ROLLOVER TO ROTH IRA

On September 18th, 2014 the Internal Revenue Service issued IRS Notice 2014-54. This notification allows employees to effectively roll all after-tax funds within their 401(k) directly into a Roth IRA.

When doing so, the associated earnings of the after-tax amount must also be rolled out, but these can then be deposited directly into a traditional IRA. By doing so, all future growth of the after-tax amount is tax-free versus taxed as ordinary income if left within the 401(k).

"Internal Revenue Service issued IRS Notice 2014-54, which allows employees to effectively roll all after-tax funds within their 401(k) directly into a Roth IRA."

In certain circumstances, for the small business owner or self-employed individual, this can be extremely helpful and quite simple to execute. The business owner can amend the qualified plan document to include two things: one of which is the plan's ability to receive after-tax contributions, the second of which is to allow for in-service distributions of these after-tax dollars.

The IRS limits annual additions (such as employee deferrals, company match, contributions) to defined contribution plans to **$55,000** per year (as of 2018).

Therefore the smart move is to defer **$18,500** and take advantage of company retirement plan matches up to **$11,000**, for a total of **$29,500**. This leaves an extra **$25,500** you can still deposit into a 401(k) on an after-tax basis. Then immediately after making this deposit, one can request this amount as an after-tax rollover that, upon receipt, is deposited directly into a Roth IRA to grow tax free.

SPECIALTY AREAS: HEALTH SAVINGS ACCOUNTS, THE BEST "ROTH" EVER

Many Americans are covered by a high-deductible health care plan, and then smartly place funds into a Health Savings Account (HSA). This may be a good strategy for certain individuals as the IRS excludes HSA deposits from income and allows them to grow tax-free as long they are ultimately used to cover qualified medical costs. However, most Americans then make the mistake of using their HSA assets to actually pay for their medical expenses.

This sounds counter-intuitive on the surface, but we believe the smarter move while working is to never use these HSA assets to cover medical costs.

On the contrary, after-tax dollars, if available, can be used to cover any and all medical costs. This allows the HSA funds to be invested into a long-term growth strategy and allowed to potentially grow tax-free for many years, just like that of a Roth IRA. Then, upon retirement, these HSA funds can be used to cover medical costs. One would never use Roth IRA assets to pay for medical costs while still working, yet most Americans use their HSA dollars to do just that.

In essence, by avoiding the use of these funds until after retirement, they can grow tax-free and could be of far more value in later years when they are likely to be needed more.

SPECIALTY AREAS: 529 COLLEGE SAVINGS ACCOUNTS – OFTEN THE NEMESIS OF THE ROTH IRA

Oftentimes, parents readily add funds to 529 College Savings accounts for their kids, yet forget to maximize their own tax-free savings vehicles. We encourage every family to first contribute the maximum amount allowed to their 401(k)s ($18,500 for those under age 50), and then fully contribute to two Roth IRAs if allowed ($5,500 X 2 = $11,000). Both should be done before adding any funds to 529s. A 529 account will grow tax-free for a maximum of 18 years, whereas adding to their own Roth IRAs helps provide tax-free growth for the entirety of their own lives and that of their children as well. Then, when college comes around, parents can simply use cash flow, other assets, or debt to pay for college while allowing previous Roth investments to continue to grow tax-free.

SPECIALTY AREAS: ROTH RECHARACTERIZATIONS

Various strategies of executing Roth conversions include separating the Roth IRA before the conversion and converting to separate Roth IRA accounts based on the investment strategy (i.e. US Equities, International Equities, and Fixed Income). Should a re-characterization be required, the account with the worst performance can be re-characterized.

CONCLUSION

While these Roth IRA investment strategies are not necessarily original or unique to the team at Dashboard Wealth Advisors, they are an example of a Family Office approach to wealth management. It is only by fully taking into account all aspects of an estate that an advisor can be at maximum effectiveness to a family's current and future finances. This Family Office approach should be implemented by long-term, trusted advisors who work side-by-side with the entirety of the family's team of accountants and legal counsel.

With all areas of expertise aligned, investment strategies such as those outlined above can be brought to fruition and carefully help guide our clients down the path of long-term success for the future of the family.

The information has been obtained from sources considered to be reliable, but do not guarantee that the foregoing material is accurate or complete. Any opinions are those of Scott Schuster and Paul Casazza and not necessarily those of Raymond James. Like Traditional IRA's, contribution limits apply to Roth IRAs. In addition, with a Roth your allowable contribution may be reduced or eliminated if your annual income exceeds certain limits. Unless certain criteria are met, Roth IRA owners must be 59 ½ or older and have held the IRA for five years before tax-free withdrawals are permitted. Additionally each converted amount may be subject to its own five year holding period. Converting a traditional IRA into a Roth IRA has tax implications. Every investor's situation is unique and you should consider your investment goals, risk tolerance and time horizon before making any investment. Prior to making an investment decision, please consult with your financial advisor about your individual situation. Investors should consult a tax advisor before deciding to do a conversion. Investing involves risk and you may incur a profit or loss regardless of strategy selected. The hypothetical examples above are for illustration purpose only and does not represent an actual investment. RMD's are generally subject to federal tax and may be subject to state taxes. Consult your tax advisor to assess your situation. You should discuss any tax or legal matters with the appropriate professional.

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