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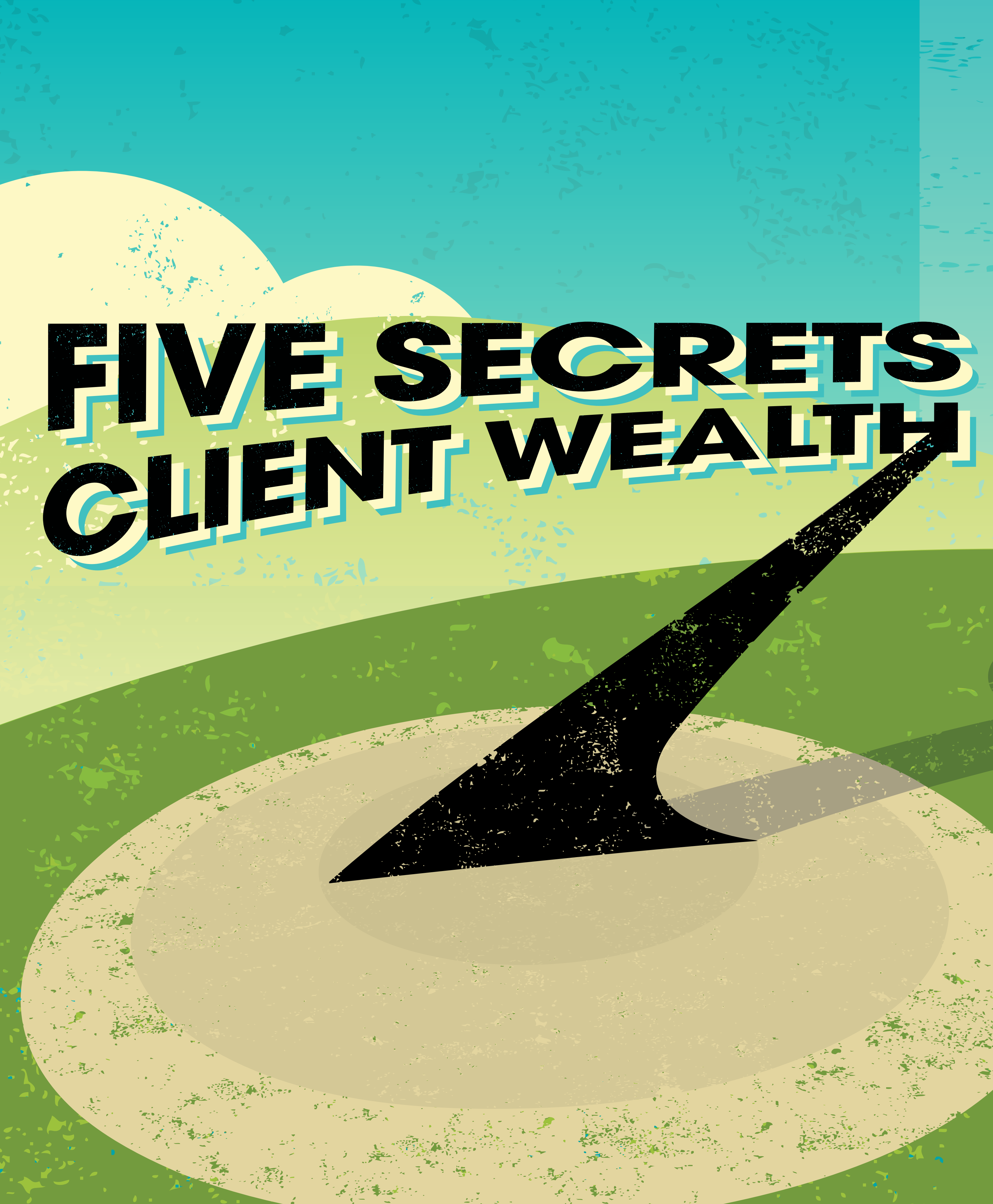

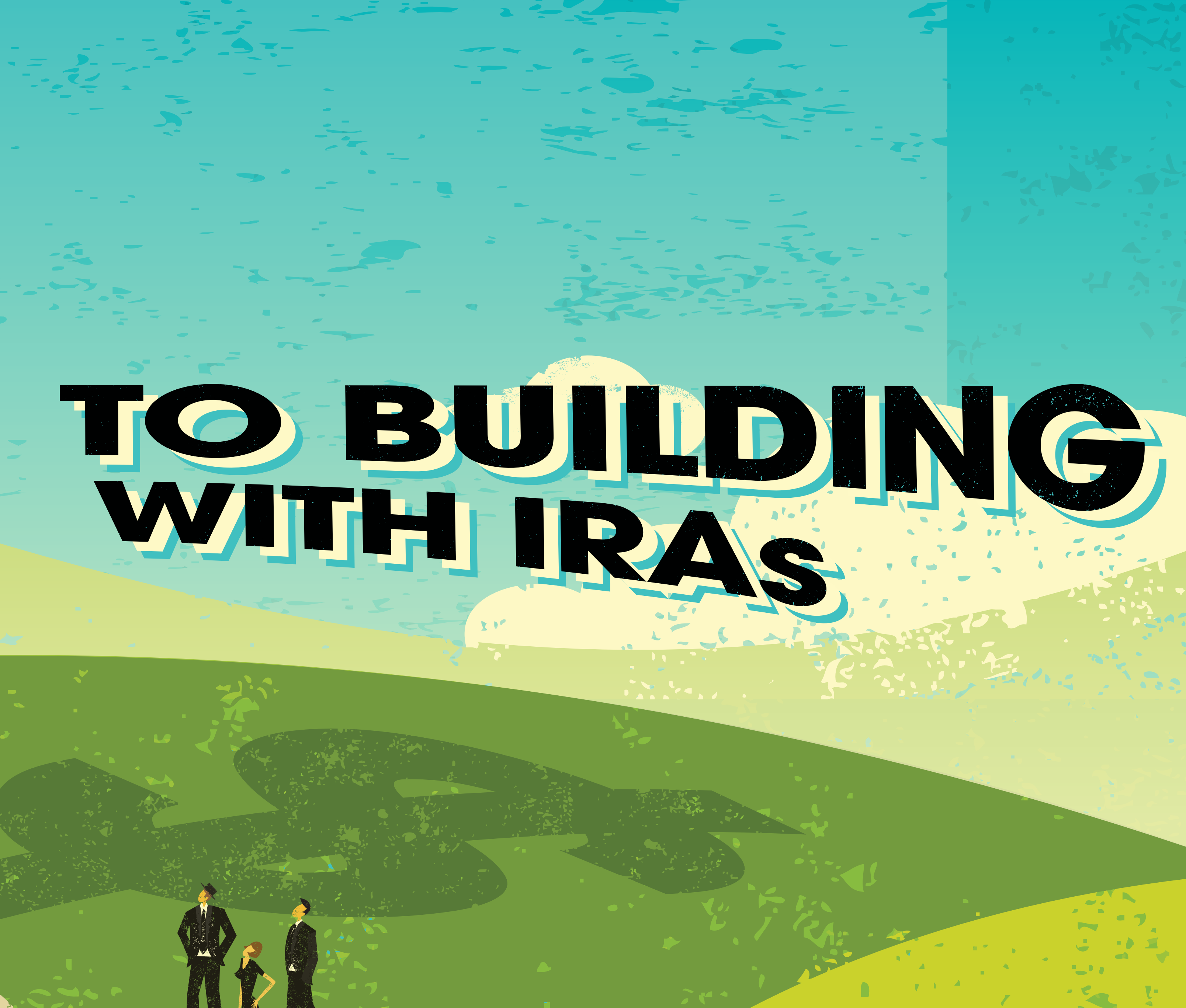

TO BUILDING WITH IRAs

By Thomas A. Gorczynski, EA, USTCP

Enrolled agents typically focus on compliance, asking such questions as: How do we complete the required forms correctly? How do we determine the correct amount of tax? Are the positions we take on tax returns likely to meet our ethical and legal requirements?

However, to be the most effective tax professional possible, and the best advocate for our clients, we must move beyond compliance and form preparation to proactive tax planning. With the movement toward tax simplification over the long term for taxpayers with relatively simple tax returns, enrolled agents will need to be forward-thinking tax planners in order to attract and retain high-net-worth individuals and business clients.

Proactive tax planning seeks to use the tax law to the advantage of our clients with two key goals in mind. The first goal is the reduction of current and future tax liabilities. Meeting this goal over many years leads to the second goal: a material increase in our clients' overall wealth due to our actions.

Many of our clients have either traditional or Roth IRAs, but they are not using these vehicles to their fullest potential. In addition, we often are not advising clients to leverage these tax-savings vehicles to increase their long-term financial positions.

Following are five strategies that enrolled agents can use to help their clients reduce tax and build wealth with respect to IRAs.

Strategy #1: Tax-Free Required Minimum Distributions

Traditional IRA owners must begin to draw-down their accounts starting in the tax year that they turn age 70.5. The taxpayer must take his or her first required minimum distribution (RMD) no later than April 1 of the calendar year following the year in which the taxpayer reaches age 70.5 regardless of "retirement" status.[1] The taxpayer must take all subsequent RMDs no later than Dec. 31 each year.[2]

If a taxpayer has reached age 70.5, then he or she can instruct the IRA custodian to direct up to $100,000 per year of IRA funds to go directly to a charitable organization listed in IRC §170(b)(1)(A) (which is the list of organizations for which a taxpayer can take a charitable contribution deduction).[3] The taxpayer then excludes the distribution from income and does not get a charitable contribution amount for the distribution amount. This is a qualified charitable distribution (QCD).

Rather than directly take the RMD as cash, a taxpayer can satisfy his or her RMD requirement with a QCD. A taxpayer can, of course, take more than the RMD amount out of the IRA tax-free to meet charitable, gifting, or estate planning goals.

Because the QCD is an income exclusion provision, the distribution amount does not increase adjusted gross income (AGI) or taxable income, which can affect eligibility for other tax benefits, including the new §199A. Additionally, the QCD does not increase the taxability of Social Security benefits.

Because the Tax Cuts and Jobs Act of 2017 (TCJA) substantially increased the standard deduction, fewer taxpayers overall—but especially those in retirement—will itemize deductions. Thus, the QCD is the best way to get a tax benefit for charitable contributions once a taxpayer is age 70.5 or older.

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Strategy #2: The "Back-Door" Roth IRA

Certain higher-income taxpayers cannot make direct contributions to a Roth IRA. For tax year 2018, the phaseout starts at a modified AGI of:[4]

- $120,000 for single, head of household, or married filing separately and lived apart for the entire tax year
- $189,000 for married filing jointly or qualifying widower or
- $0 for married filing separately and lived with the spouse for any part of the tax year

However, the back-door Roth IRA strategy allows for an indirect Roth IRA contribution even if the tax law prohibits a direct Roth IRA contribution due to income limitations.

The back-door Roth IRA contribution is a simple two-part process. First, the taxpayer makes a nondeductible traditional IRA contribution. Second, the taxpayer converts the IRA balance into a Roth IRA.

Since the taxpayer's basis in the traditional IRA equals the balance of the IRA, the conversion amount is completely tax free,[5] and the funds ultimately end up in the Roth IRA, even if the taxpayer's income would normally prohibit a direct Roth IRA contribution.

It is important to note the following limitations with regard to the back-door Roth IRA strategy:

- The taxpayer must have sufficient earned income to make the nondeductible IRA contribution. For IRA purposes, earned income includes wages, self-employment income, and alimony income.[6]
- Because a taxpayer can no longer make traditional IRA contributions starting in the tax year he or she attains age 70.5, a back-door Roth IRA is not available to taxpayers over 70.5.[7] On the other hand, direct Roth IRA contributions have no age limit.
- The back-door Roth IRA contribution works optimally only when there are no other traditional IRA assets. If there are other traditional IRA assets (including SIMPLE IRAs and SEP IRAs), then the nondeductible contribution spreads throughout all the IRA assets, causing a partially taxable conversion. This is due to the "cream-in-the-coffee" rules: If a taxpayer makes nondeductible IRA contributions, then each IRA distribution contains a *pro rata* share of the IRA's basis, regardless of which of the taxpayer's IRAs had the nondeductible contributions.[8]
- Assuming no other traditional IRA assets, if the amount in the traditional

IRA fluctuates after the nondeductible contribution, then it can complicate the back-door Roth IRA strategy; therefore, putting the amount in cash or cash equivalent is best to avoid value changes.

Some commentators have expressed concerns about the back-door Roth IRA strategy as contrary to the intent of the tax law and at potential risk of disallowance under the step transaction doctrine.

The conference report for the TCJA clearly states that the back-door Roth IRA is a strategy allowed under current law in footnote 269:

> Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.[9]

Some additional considerations for the back-door Roth IRA strategy are:

- For a married couple filing a joint return, a nonworking spouse can use the back-door Roth IRA strategy provided the working spouse has sufficient earned income to cover the nondeductible contribution for the nonworking spouse.
- If a taxpayer rolls a distribution from a traditional IRA to a non-IRA retirement plan, then the law requires that the distribution comes entirely from the taxable portion of the IRA if the IRA has basis.[10]

Therefore, if the taxpayer has a §401(k) or similar non-IRA plan, then the taxpayer can roll over either (1) all traditional IRA assets if no basis is present, or (2) all taxable IRA amounts if the traditional IRA assets have basis. This allows a completely tax-free back-door Roth IRA once he or she moves all taxable amounts into the §401(k) plan.

Example 1

Grace has $75,000 in a traditional IRA with a basis of $15,000. If Grace has a qualified retirement plan (QRP) at work that accepts rollovers, Grace can roll over $60,000 to the QRP, leaving $15,000 in the IRA with a basis of $15,000. Grace can convert all $15,000 to a Roth IRA tax-free, then in future years use the back-door Roth IRA strategy since all taxable retirement assets are in the QRP.

Strategy 3: Tax-Free (or Low-Tax) Roth IRA Conversions

A tax-free Roth IRA conversion is a true win–win scenario for the taxpayer: he or she gets a tax deduction up front and will withdraw the funds tax free and penalty free from the Roth IRA in retirement.

If a taxpayer has no or little taxable income during a tax year, then he or she can convert traditional IRA assets to Roth IRA assets to fully absorb the standard or itemized deduction. This converts the assets tax free.

A taxpayer could also convert amounts in excess of the standard or itemized deduction amount and pay only a 10 or 12 percent marginal tax rate on the conversion amount exceeding the deduction amount.

In addition, if a taxpayer will have unused tax credits, then a Roth IRA conversion could absorb those tax credits and increase the amount converted tax free.

Example 2

In 2018, Kate is a full-time, single graduate student. Her tuition and fees are $15,000 annually, and she has only $5,000 in wage income from a part-time job. She has $35,000 in a traditional IRA.

Kate can convert up to $25,200 of her traditional IRA to a Roth IRA and incur no federal income tax on the conversion due to her use of the standard deduction and lifetime learning credit.

Alternatively, Kate could convert her entire $35,000 traditional IRA to a Roth IRA. The total federal tax cost to convert the $35,000 is $1,170, for an effective federal tax rate of 3.3 percent on the conversion amount.

If a taxpayer has a net operating loss deduction (NOL) in a taxable year, or other large current-year ordinary loss, then the taxpayer could absorb the loss with a Roth IRA conversion and convert significant portions of his or her traditional IRA assets tax free.

The TCJA made significant changes to the general ability to gain an immediate tax benefit for NOLs arising in tax years beginning after Dec. 31, 2017:

- The taxpayer cannot carry back the NOL two years to generate an immediate refund (except for certain farming NOLs).[11]
- The tax law limits the NOL deduction in subsequent years to 80 percent of taxable income.[12]

Since the TCJA reduced the ability of a taxpayer to get an immediate tax benefit from a NOL, the Roth IRA conversion strategy is one way to get an immediate tax benefit from the NOL and build tax-free retirement assets.

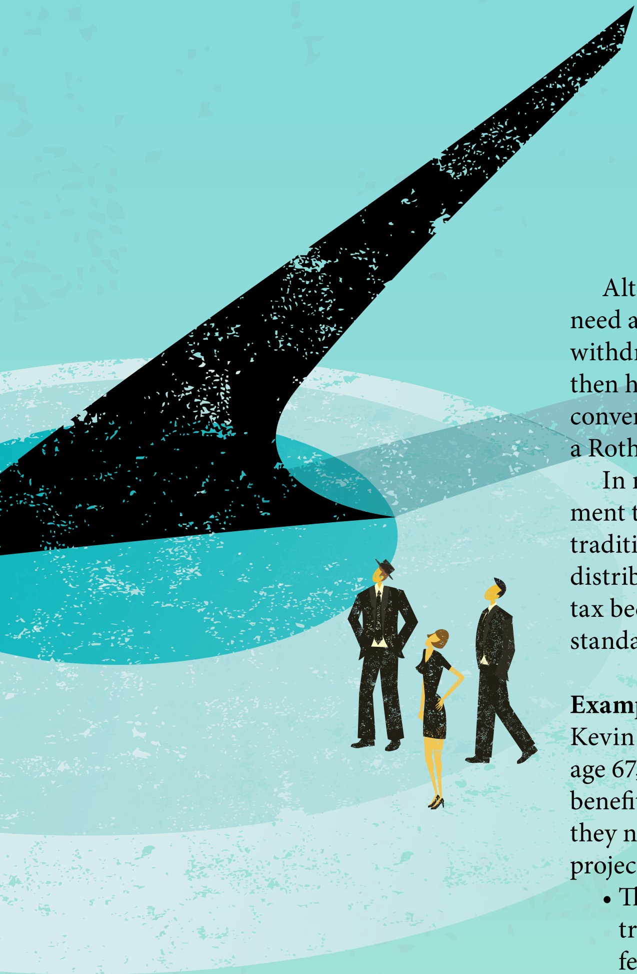
Example 3

In 2018, John, a single taxpayer, takes the standard deduction and has a Schedule C loss of $30,000. John has no other tax items on his tax return. John has $55,000 in traditional IRA assets.

Based on the above information, John can convert $42,000 to a traditional IRA in 2018 and pay no tax on the conversion amount on his 2018 tax return. John will then have no NOL carryover to tax year 2019.

If John does nothing with his traditional IRA assets, then he has a $30,000 NOL carryover to 2018, which John can use to reduce, but not completely eliminate, his 2019 tax.

Alternatively, John can convert less than the tax-free maximum and carryover a predetermined amount to tax year



2019, perhaps based on his projected 2019 taxable income.

Strategy 4: Tax-Free (or Low-Tax) Traditional IRA Distributions

A tax-free traditional IRA distribution is also a true win–win scenario for the taxpayer: he or she generally gets a tax deduction up front and later pays no tax on the distribution.

If a taxpayer has an NOL in a taxable year, or other large current-year ordinary loss or unused deductions or credits, then he or she could absorb the loss with a traditional IRA distribution. This could offset the income tax attributable to the distribution, but not the 10 percent additional tax if under age 59.5.[13]

If the taxpayer is over age 59.5, then using this strategy could get monies out of a traditional IRA both tax free and penalty free. The taxpayer could then invest the monies into investments that generate tax-free income or long-term capital-gain income, which is taxed at preferred rates, possibly as low as 0 percent.

Alternatively, if the taxpayer does not need all the monies that he or she could withdraw free from federal income tax, then he or she could use the extra space to convert amounts from a traditional IRA to a Roth IRA tax free.

In retirement, the taxpayer can implement this strategy by first distributing traditional IRA assets to the extent the distribution would incur no federal income tax because the taxable income is below the standard or itemized deduction amount.

Example 4

Kevin and Scott, a married couple both age 67, receive $24,000 in Social Security benefits in 2018. They determined that they need $50,000 in income to meet their projected living expenses in 2018.

- They can withdraw $22,660 from their traditional IRA assets and incur no federal income tax.
- If they withdraw $27,000 from a traditional IRA, then they will have $50,350 in after-tax cash, after paying $650 in federal income tax.
- If they only withdraw $22,660 from their traditional IRA assets, then they will need to withdraw $3,340 in Roth IRA assets to make up the difference, saving them $650 total compared to the all-traditional IRA strategy.

If Kevin and Scott only need $40,000 per year in income to meet their projected living expenses, then they only need to withdraw $16,000 in traditional IRA assets. They could then convert $6,660 in traditional IRA assets to Roth IRA assets and continue to pay no federal income tax in 2018.

Strategy 5: Substantially Equal Periodic Payments

The substantially equal periodic payments (SEPP) exception to the 10 percent additional tax for early traditional IRA withdrawals is a powerful tool to allow taxpayers to tap their traditional IRA assets for an income stream prior to age 59.5. It is underutilized as a tax, financial, and estate planning strategy.

When using this exception, it is critical that the taxpayer closely follows Revenue Ruling 2002-62 to avoid serious problems. Unless indicated otherwise, the authority for the following information is Revenue Ruling 2002-62.

The SEPP rules allow a taxpayer to design a plan that meets his or her financial goals by tailoring the plan details to produce the distribution amounts desired. A taxpayer does not have to maintain the SEPP for his or her entire lifetime; rather, the distributions must continue for five years or until the taxpayer reaches age 59.5, whichever is *later*.[14]

The below items are a simplified listing of the interrelated choices the taxpayer must make to design the payment stream desired:

- The taxpayer selects one of three permitted methods: the RMD method, the amortization method, or the annuitization method. If the taxpayer wants to use a different method, then he or she can request approval via a private letter ruling.
- The taxpayer chooses a life expectancy table on which to base the calculation.
- The taxpayer chooses an interest rate and whether or not to use "annual recalculation." These options do *not* apply to the RMD method.
- The taxpayer selects the payment schedule: monthly, annually, or quarterly.
- The taxpayer bases the SEPP on the account balance of one IRA, a series of IRAs, or all IRAs; therefore, the taxpayer can use IRA rollovers to get the IRA balance to a precise amount.[15]

The RMD method is the simplest method. Under this method, the taxpayer calculates the payment amounts in the same manner as an RMD. However, the payment amounts will vary from year to year based on the prior year-end balance; therefore, this method does not produce a fixed stream of income.

FIVE SECRETS TO BUILDING CLIENT WEALTH WITH IRAs

Under the amortization method, the taxpayer selects a reasonable interest rate and a life expectancy table and then takes regular payments as if the account were a self-amortizing level payment mortgage. Once the taxpayer determines the first payment amount, it does not vary unless the taxpayer elects annual recalculation. If the taxpayer initially selects the amortization method, then the taxpayer has the option to switch to the RMD method in any year after the first year.

Under the annuitization method, the taxpayer selects a reasonable interest rate and a life expectancy table and then divides the account balance by an annuity factor as if the taxpayer annuitized the account over the applicable life expectancy. Once the taxpayer determines the first payment amount, it does not vary unless the taxpayer elects annual recalculation. If the taxpayer initially selects the annuitization method, then the taxpayer has the option to switch to the RMD method in any year after the first year.

If the taxpayer modifies the SEPP plan before the required period of time has elapsed, then there is a retroactive revocation of the SEPP exception, and the taxpayer owes the 10 percent additional tax on all distributions made before age 59.5 plus interest.[16] The no-modification period starts on the date of the first distribution and ends on the later of (1) the fifth anniversary of the first distribution, or (2) the date the taxpayer turns 59.5.[17]

Modifications that trigger the SEPP exception revocation include:

- Stopping the distributions.[18]
- Taking extra distributions.[19]
- Changing the period of periodic payments.
- Adding to the account or transferring into or out of the account once the taxpayer determines the account balance for SEPP purposes.

The SEPP exception is a critical tool to finance early retirement or other financial, investment, or estate planning goals. These goals are specific to each taxpayer. Two potential examples for use of a SEPP beyond early retirement include:

- If a taxpayer needs capital to start a business, or fund an investment, then the taxpayer can obtain an unsecured loan or a home equity loan and pay the monthly loan payments with the SEPP. The IRA distribution amounts are penalty free, and the potential deduction of the interest as either business interest or investment interest reduces the tax impact of the taxable IRA distribution.
- If IRA assets are a disproportionate amount of a taxpayer's assets, then the taxpayer can use the SEPP exception to transfer assets outside of the IRA assets penalty free. The taxpayer can potentially invest funds moved out of the IRA assets into capital gain-generating investments, which are subject to preferential tax rates when compared to ordinary rates when distributed from the IRA.

Conclusion

IRAs are often an overlooked tool in the tax planner's toolkit. Whether our clients are low or high income, a wage earner or self-employed, or working or retired, one (or more) of the above strategies is available to help build long-term wealth. This upgrades the enrolled agent from someone who merely completes tax forms to a valued financial partner.

When considering fees for providing proactive tax planning services (and, yes, tax planning is a completely separate service from compliance and merits additional fees), consider not only the time spent on the engagement, but the value—both short and long term—that you are providing. Do not undervalue the long-term wealth you help your clients build with proactive tax planning strategies. EA

For Your Review

1. What is the maximum a taxpayer may exclude from income each year with a qualified charitable distribution?

A. $50,000
B. $100,000
C. $150,000
D. $200,000

2. The back-door Roth IRA strategy is essentially a:

A. Direct Roth IRA contribution
B. Taxable Roth IRA conversion
C. Nontaxable Roth IRA conversion
D. Deductible traditional IRA contribution

*See page 60 for the answers.

About the Author

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ENDNOTES

1. §408(a)(6); §401(a)(9)(C)(i)(I), (ii)(II).
2. Treas. Reg. §1.401(a)(9)-5, A-1.
3. §408(d)(8).
4. www.irs.gov/retirement-plans/plan-participant-employee/amount-of-roth-ira-contributions-that-you-can-make-for-2018
5. §408(d); §72(e).
6. §291(f)(1).
7. §219(d)(1); §408(o)(2)(B)(1).
8. §408(d); §72(e).
9. TCJA Conference Committee Report, p. 114.
10. §408(d)(3)(H)(ii).
11. §172(b)(1)(A).
12. §172(a)(2).
13. §72(t).
14. §72(t)(4)(A)(ii).
15. PLR 9747039.
16. §72(t)(4)(A).
17. §72(t)(4)(A).
18. PLR 9818055.
19. *Arnold v. Commissioner*, 111 T.C. 250 (1998).