PFS | PHYSICIANS FINANCIAL SERVICES

ClientAdvisor

JUNE 2022

Roth removes requirements

Avoid required minimum distributions (RMDs) in down markets; pair tax liability with charitable and other structures.

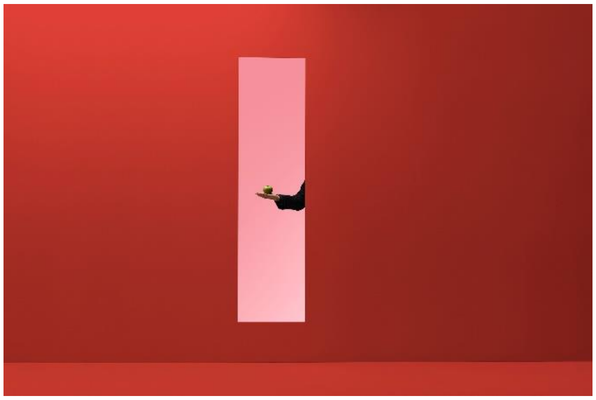
As the country continues to deal with rising federal budget deficits, underfunded entitlement programs, and turbulent markets, increased taxes on forced portfolio withdrawals in retirement are one of the greatest risks and uncertainties for our clients and the investing public.

Accordingly, successful doctors take advantage of a **Roth conversion** of money in their qualified accounts (401k, IRA) to remove this uncertainty and lock in tax-free growth.

There are no income limits for a Roth conversion and, while they may trigger a taxable event, successful physicians can mitigate their tax bills by pairing strategies with our other structures.

"Back-door" Roth v. Subsequent Conversion

Separate from a Roth conversion of an existing pre-tax qualified account, successful physicians seek to contribute to a Roth IRA during their working life. For those whose income is too high to do so (known as "Roth ineligible")[1], they utilize a "back door" Roth, which is really a two-step process:



1. Opening a non-deductible traditional IRA and making after-tax contributions, filing IRS Form 8606 every year.

2. Transferring the assets from the traditional IRA to a Roth IRA. This transfer and conversion can be made at any time, but often a waiting period of a few months is recommended.

There are still limits to this benefit. Contribution limits for both traditional and Roth IRAs remain at a paltry $6,000 per year, and the IRS is only likely to provide incremental increases to these limits in the years ahead. Most successful physicians have significant surplus income and are deferring far greater assets into a variety of our tax-deferred structures, such as Defined Benefit, Cash Balance, Profit Sharing, Money Purchase and combination pension plans. Thus, this strategy is not meaningful.

Furthermore, this "back door" may be imminently closing. While currently legal under US law, the IRS may be changing its stance on this investment strategy. Congress is also considering legislation that would prohibit or dramatically curtail its availability.

Subsequent and Superior: Roth Conversion

In contrast to a "back door" Roth strategy for ongoing contributions, many successful physicians act further along in their working life, or when approaching retirement. Substantial pre-tax dollars have funded qualified retirement plans (401k, IRA, money purchase, profit sharing, cash balance, and pension plans) along the way, and face a looming tax threat.

2022's market volatility has crystallized the vulnerability of these pre-tax dollars being subject to Required Minimum Distributions (RMDs). In addition to the unknown future tax obligation at the time of withdrawal, the IRS also forces (through RMDs) pre-tax dollars to be withdrawn each year, regardless of the market's conditions, leading to a vulnerable position of "locking in losses" due to market turmoil.

[1] Married joint filers with more than $214,000 in adjustable gross income (AGI), or single filers earning more than $144,000 AGI (2022 limits). A full chart detailing limitations on Roth contributions is available on the IRS website.

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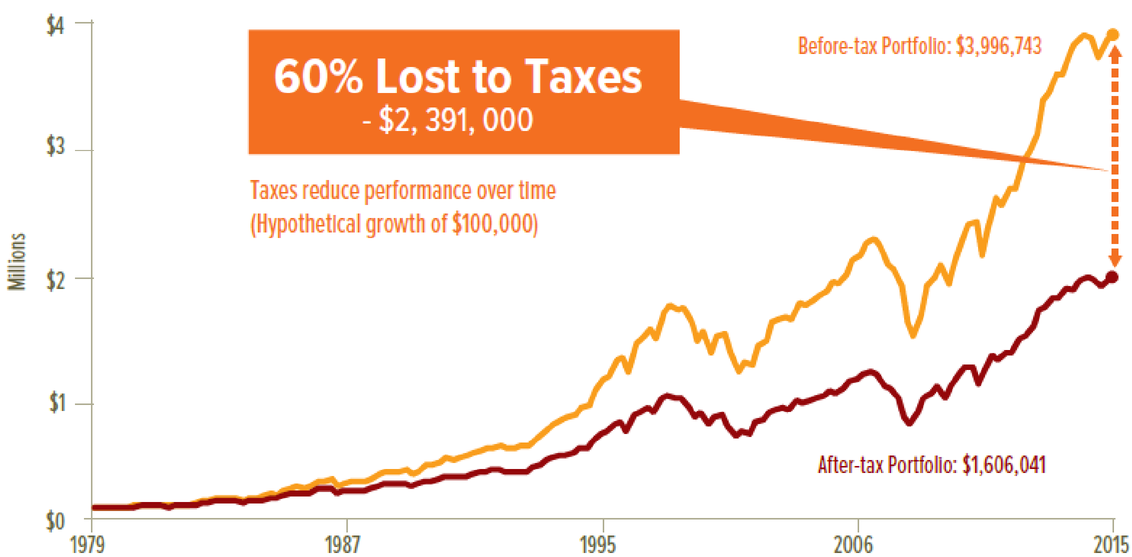
Tax-efficiency: equally important as returns, but often overlooked. While creating a risk profile, allocating assets to a diversified strategy, and periodic rebalancing are building blocks of successful long-erm investing, focusing solely on generating returns can overlook the need for tax-efficiency. Taxes are the single largest drag on performance for investors over the long term, and the longevity of retirement income. A Roth conversion is a critical component in solving for these issues.

FIGURE 6 Its not what you make, its what you keep



Source: Parametric Portfolio Associates. Based on a hypothetical tax-free $100,000 portfolio invested 60% in stocks (based on the Russell 3000®) and 40% bonds (based on the Barclays Aggregate) with (1) no liquidators; (2) interest income and dividends taxed annually at historical top marginal tax rates; (3) capital gains realized at 50% per year and taxed at the historical long-term capital gains tax rate; and (4) portfolio is held for 36 years from (1979–2015). The intent is to portray a worst-case scenario. The portfolio would have grown from $100,000 to about $4.0 million. If the portfolio was taxed as indicated above, it would have lost 60% of its value, due to taxes paid and earnings lost on that money. Tax-managed investment strategies are designed to minimize capital gains distributions and maximize after-tax returns. Past performance is no guarantee of future results.

Pairing tax liability with a charitable offset. Roth conversions do trigger a taxable event in the year they are executed. Though future growth, withdrawals, and investment changes will be free of taxable consequence, there is still a need to time the Roth conversion to a favorable tax year and pair it with other strategies to mitigate the taxable consequence.

Many successful physicians can mitigate their tax bills from a Roth conversion by pairing structures. For instance, a client could utilize charitable projects that offer an outsized deduction in relation to the initial contribution, as well as other unique strategies we offer to offset the single year tax liability from their Roth conversion.

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The mechanics of a Roth conversion are as follows:

- The plan administrator of the qualified plan where money is currently held on a pre-tax basis is contacted, and furnished forms to rollover the balance.
- A new Roth IRA is opened and forms from the qualified plan sponsor are used to request a direct rollover to the Roth IRA.
- The amount rolled over is subject to income tax at ordinary income rates for the year when the conversion takes place. When possible, successful physicians pick a year when income is lower than usual, and/or they pair the conversion is paired with charitable projects and other structures to offset the liability.

Is a Roth conversion right for you? An individual consultation--without financial commitment or obligation to our firm--can produce customized financial planning tailored to one's individual risk profile, tax-optimization needs, and lifelong objectives.

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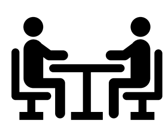
Schedule a Consultation



Schedule a Client Review

IRA Contribution Limits

Per IRS regulations for 2022, 2021, 2020 and 2019, the total contributions you make each year to all of your traditional IRAs and Roth IRAs can't be more than $6,000 ($7,000 if you're age 50 or older), or If less, your taxable compensation for the year. For 2018, 2017, 2016 and 2015, the total contributions you make each year to all of your traditional IRAs and Roth IRAs can't be more than $5,500 ($6,500 if you're age 50 or older), or If less, your taxable compensation for the year. The IRA contribution limit does not apply to rollover contributions, or qualified reservist repayments.

Limits on Roth IRA contributions based on modified AGI

Your Roth IRA contribution might be limited based on your filing status and income. Per 2022 IRS rules, Married joint filers with more than $214,000 in adjustable gross income (AGI) may not contribute to a Roth IRA (single filers earning more than $144,000 are also ineligible). A full chart detailing limitations on Roth contributions is available on the IRS website.

5 Year Holding Period

Roth IRA conversions require a 5-year holding period before earnings can be withdrawn tax free and subsequent conversions will require their own 5-year holding period. In addition, earnings distributions prior to age 59 1/2 are subject to an early withdrawal penalty.

Indirect 401(k) Rollovers

Another option to effectuate a Roth conversion is to take an indirect rollover. In this case, the plan administrator will send a check after withholding taxes at a rate of 20%, and the client then records the distribution and the taxes already withheld on their income tax return. Note that funds withdrawn from a 401(k) must be rolled over to another retirement account within 60 days to avoid taxes and penalties.

Avoid Cashing Out

Cashing out your 401(k) account, in whole or in part—whether the account is traditional or Roth—is usually a mistake. On a traditional 401(k) plan, a participant cashing out their balance will owe taxes on all contributions, plus the 10% for early withdrawals if they are under age 59½. On a Roth 401(k), they will owe taxes on any earnings that they withdraw and be subject to the 10% early withdrawal penalty if they're under age 59½ and have not had the account for five years.

Disclaimer

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