Wealth Planning **Update**

Getting the most from Roth IRAs and Roth 401(k)

Roth IRAs have been in existence since 1998 and since 2006, the ability to make Roth 401(k) contributions has been permitted. Roth IRAs have several advantages—tax free growth, tax free distributions (subject to a holding period requirement), and no required distributions during the lifetime of the Roth IRA owner or their spouse.

However, there is no income tax deduction for contributions to a Roth IRA or Roth 401(k) as there are for traditional IRAs or 401(k). Funds can be placed in Roth accounts through either contributions or conversions of IRA accounts.

For Roth distributions from contributory accounts to be tax free, they must be after the account owner reaches age 59½, or on account of the owner's death or disability AND five tax years must have passed between the contribution and the distribution. For example, if a taxpayer makes a contribution to a Roth IRA on April 14, 2018 for the 2017 tax year, the contribution is treated as if made on 1/1/2017—and then (if over age 59.5, could be withdrawn income tax free after 12/31/21. For contributory Roth IRA's, you only need to meet this five year requirement once—for any future contributions, the clock starts with the tax year of the first contribution. For conversions of IRAs to Roth IRAs, each conversion has its own separate five year clock.

In order to make full contributions to a Roth IRA, you must first have earned income (wages or self-employment) and your income must not exceed $120,000 for single tax payers or $189,000 for joint taxpayers.

2018 Roth IRA limits	Single	Married
Contribution limit	$5,500	$5,500
Extra if age 50 or older	$1,000	$1,000
Full contribution if income below	$120,000	$189,000
No contribution if income above	$135,000	$199,000

Back Door Roth IRA contributions

If your income exceeds the limits for Roth IRA contributions, you may be able to complete a Back Door Roth Contribution. With a back door Roth contribution, you first make a contribution to a non-deductible IRA and then convert your IRA to the Roth IRA. If you do not have other IRAs, the conversion should be a tax free event. However, if you have other IRAs, the tax code treats all of your IRAs as a single IRA and only part of the conversion would be tax free.

For example, if you have an existing IRA of $95,000 and then make a non-deductible contribution of $5,000 and convert $5,000, only 5% of the conversion would be tax free ($5,000 after tax /$100,000 combined IRA balances).

Since 2010, taxpayers of any income level have been able to complete Roth IRA conversions. For many years, practitioners have been concerned the IRS could view the back door contribution as a step transaction (multiple steps to achieve a desired end result—the contribution to a Roth IRA—that was not permitted specifically by the tax code). When the 2017 Tax Act was passed, Congressional Committee notes stated: "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, as discussed below."

Continued

Mega Back Door Roth

A less well known strategy is the Mega Back Door Roth and involves a company retirement plan such as a 401(k) or 403(b) plan. A caution in that, currently, only about 10% to 15% of the 401(k) plans allow the flexibility needed for this strategy. The rules governing these plans state that the maximum deferral (for 2018) is $18,500 and total contributions to the plan for the employee and employer cannot exceed $55,000 or 25% of compensation (not counting the permitted $6,000 extra for a participant age 50 or older). Includable compensation is also limited to no more than $220,000. The plan then has to permit contributions in excess of the deferral limit (this is a tax deferral limit but not a contribution limit).

Total wages	$220,000
Maximum plan contribution (25%)	$55,000
Pre-tax deferral	($18,500)
Company match (example of 4%)	($8,800)
Potential after-tax employee contribution	$27,700

At a minimum, the after tax amount is segregated and then, upon complete plan distribution, can be rolled over to a Roth IRA with pre-tax amounts going to a traditional IRA. Other plans may allow in–service distributions which could permit periodic roll-overs to Roth IRAs and traditional IRAs. Other plans have permitted in-plan conversions of after tax 401(k) balances to Roth 401(k) balances. Each client / company situation is unique and should be reviewed to determine if this is a viable option for your circumstances.

Roth IRA conversions

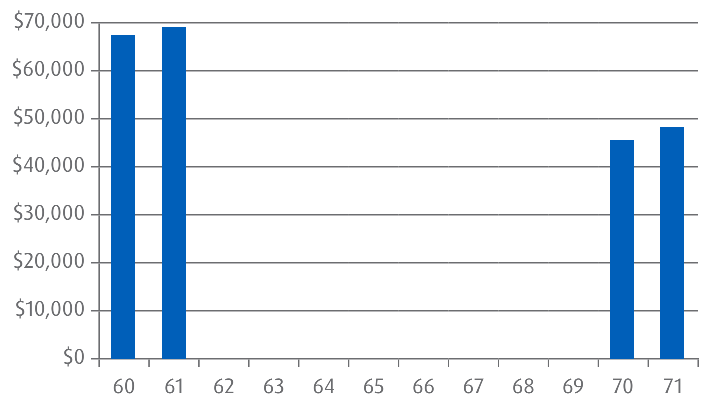
A conversion involves moving funds from an existing traditional IRA to a Roth IRA. When funds are moved, it triggers income tax on the amount converted (moved) from a regular IRA to a Roth IRA. Conversions can be done at any time—while working or retired or even while taking minimum distributions. However, while working, you may be in a high income position already and may not want to add additional taxable income. When you have started required minimum distributions (after age 70½), you must first take the required distribution before completing any conversion—again adding taxable income when income may already be high.

Prior to 2018, you could make a Roth Conversion and then would have until filing your income taxes (including extensions) to reverse your decision if it later was determined you were not comfortable with the tax on the conversion. However, with the 2017 Tax Act, the ability to reverse a Roth Conversion is no longer allowed (2017 conversions can still be reversed until filing 2017 income taxes—potentially until October 15, 2018).

For many of our clients, the window after ceasing paid work and before required retirement distributions begin may be the most optimal time to complete conversions.

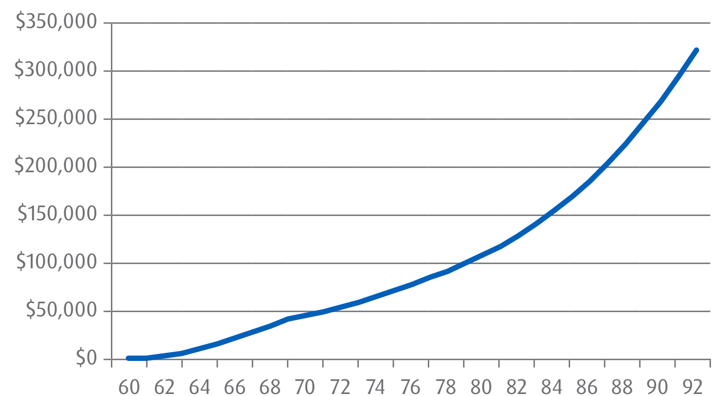
Consider the chart below. We have assumed a 60 year old, currently working making $250,000 per year. Further, we assumed they have $2.5 million in a taxable investment account and $2.5 million in tax deferred retirement accounts. Social Security is assumed to be deferred to age 70. Even with $5 million of financial assets, there may be no income taxes between age 63 and age 70.

Taxes



Next, we assume the couple converts $75,000 annually from their retirement plan to their Roth IRA in the years between age 62 and age 69. You will note small gains in total assets during the conversion years (62–69) but then the great increase in assets in the years after age 70. This results from what is likely the most beneficial feature of a Roth IRA compared to a traditional IRA—no required distributions during the lifetime of the account owner or the spouse beneficiary.

Increase in after tax assets from Roth IRA conversions



In addition to benefits of strategic Roth IRA Conversions, having a Roth IRA, with a taxable investment account and a traditional IRA offers more options for choosing which funds to use to fund your lifestyle in retirement.

Enhanced tax diversification

In addition to benefits of strategic Roth IRA Conversions, having a Roth IRA, with a taxable investment account and a traditional IRA offers more options for choosing which funds to use to fund your lifestyle in retirement.

Depending on other income and expenses in a year, it could be helpful to sell appreciated stocks in a taxable account or draw more than required from a traditional IRA in years where taxable income is low and then have the flexibility to take tax free withdrawals from the Roth IRA in years where taxable income is high.

Estate transfer benefits

A Roth IRA may also provide benefits as part of your overall estate plan. Traditional IRAs are included in your taxable estate at their full value—even though your heirs will still need to pay income tax when they withdraw funds—so you end up paying estate tax on money that will go to income taxes. (Note, there is an itemized deduction available to beneficiaries of inherited IRAs to offset some of the impact of the "estate tax on the income tax"—but most beneficiaries fail to take this deduction). Converting IRA assets to a Roth IRA during your lifetime can reduce the amount of an estate subject to estate taxes. The conversion then also provides a tax free income stream to your beneficiaries.

Dave Bensema, CPA, CFP®, is the BMO Private Bank Regional Leader of Wealth Planning for the Chicago and Suburban Illinois Regions. Dave is an active member of the DuPage Estate Planning Council. He has over 20 years of experience in the financial services industry.

When conversion may not make sense

Lack of non-IRA assets

Ideally, it is best to pay the tax on a Roth Conversion with assets that are not in an IRA. In doing so, the amount of taxes paid act like an additional contribution to the Roth IRA. If funds are withdrawn from an IRA to pay income tax on the conversion, the amount withdrawn is subject to income taxes and may also be subject to the 10% penalty if withdrawn before age 59½.

Charitable goals

If you have plans to leave funds to a charity at your passing, a tax deferred asset such as a 401(k) or IRA may be the ideal asset to leave to a charity. The charity will not pay income taxes or estate taxes on the transfer. In addition to a bequest at death, you may also be able to take advantage of "qualified charitable distributions" (QCD). A QCD is a distribution from an IRA directly to a charity for an account owner over age 70½. The distribution is not reported as income and you do not take the deduction. While this may seem the same as taking a distribution and then making a donation, by completing the QCD, your reported adjusted gross income would be lower—which may result in lower Medicare premiums as well as smaller hurdles for various itemized deductions.

Feel confident about your future

BMO Wealth Management—its professionals, its disciplined approach, its comprehensive and innovative advisory platform—can provide financial peace of mind.

For greater confidence in your future, call your BMO Wealth Management Advisor today.

www.bmowealthmanagement.com

Source: IRS Notice 2014-54 Acquiesces On Splitting After-Tax 401(k) Contributions for Roth Conversion

The information and opinions expressed herein are obtained from sources believed to be reliable and up-to-date, however their accuracy and completeness cannot be guaranteed. Opinions expressed reflect judgment current as of the date of this publication and are subject to change.

This information is being used to support the promotion or marketing of the planning strategies discussed herein. This information is not intended to be legal advice or tax advice to any taxpayer and is not intended to be relied upon. BMO Harris Bank N.A. and its affiliates do not provide legal advice to clients. You should review your particular circumstances with your independent legal and tax advisors.

Estate planning requires legal assistance which BMO Harris Bank N.A. and its affiliates do not provide. Please consult with your legal advisor.

BMO Wealth Management is a brand name that refers to BMO Harris Bank N.A. and certain of its affiliates that provide certain investment, investment advisory, trust, banking, securities, insurance and brokerage products and services.

BMO Private Bank is a brand name used in the United States by BMO Harris Bank N.A. Member FDIC. Not all products and services are available in every state and/or location. Investment Products are: **NOT FDIC INSURED–NOT BANK GUARANTEED–NOT A DEPOSIT–MAY LOSE VALUE**.

Certified Financial Planner Board of Standards Inc. owns the certification marks CFP® and CERTIFIED FINANCIAL PLANNER™ in the U.S.

C11# 7084735 © BMO Financial Group (06/18)