



Schwartz Financial Services

Comprehensive Wealth Management & Retirement Planning

Michael L. Schwartz, RFC®, CWS®, CF

Three Retirement Opportunities to Consider: Funding Your Retirement Plan, Custodial and Backdoor Roth IRAs

It's extremely important that you take your retirement into your own hands. The concept of a government-sponsored retirement is not the best plan. As we all know, the developed world's population is continuing to age, with fewer and fewer working-age people remaining to contribute to social security systems. On a more positive note, your retirement savings can not only help you, but it can also potentially help family and loved ones. Some people use retirement savings to help family members by contributing to their children or grandchildren's lives. Examples include: financing an educational expense, passing on assets to loved ones or simply keeping legacy assets, such as land or real estate, within the family.

Most experts agree that consistent funding of retirement plans is a healthy activity. You can still make 2016 IRA contributions until April 18, 2017. This is also a good time to consider making your 2017 retirement contributions.

The chart in this article shows the IRS changes for 2017, including income limits for those who contribute to both a traditional IRA and a workplace retirement plan (or those whose spouses have access to a workplace plan), as well as the income limits for those who contribute to Roth IRAs.

To discuss your overall retirement strategy call us and schedule an appointment.

Roth IRAs and Your Children (or Grandchildren)

Many people think they can hold off saving for retirement when they are younger and make up the difference later. Savvy investors know this can be a costly mistake. Waiting too long to start saving can make it very difficult to catch up, and only a few years can make a big difference in how much you'll accumulate. For some, having a large retirement account might seem like a nice but unattainable goal. It can become more realistic if they know the secret: **time**. *When should you start saving for retirement?* It might seem backwards to worry about the *last* money you'll need *early in life*, but because compounding over time can be so powerful, starting early gives you more flexibility later on in life. If you have children (or grandchildren) who earn money, now might be a good time to help them start or fund a retirement account. While they can always fund a traditional IRA, if they qualify, a Roth IRA might be an even better choice.

2017 IRS limits for retirement plans

Maximum workplace retirement plan contribution amounts	2016	2017
401(k), 403(b), most 457 plans and federal Thrift Savings Plan	\$18,000	\$18,000
Catch-up contributions in these plans for people 50 and older	\$6,000	\$6,000

IRA Contribution limits	2016	2017
Traditional and Roth IRAs for people younger than 50	\$5,500	\$5,500
Catch-up IRA contributions for people 50 and older	\$1,000	\$1,000
Defined benefit pension plan annual benefits limits	\$210,000	\$215,000
Annual employer limit for 401(k)-type plans, SEP IRAs and solo 401(k)s	\$53,000	\$54,000
Annual contribution limit for SIMPLE plans	\$12,500	\$12,500
Catch-up contribution limit for people age 50 and up	\$3,000	\$3,000

Adjusted gross income phaseout range of IRA deductibility	2016	2017
Single and contributing to a workplace plan	\$61,000 to \$71,000	\$62,000 to \$72,000
Married filing jointly when the spouse making the contribution has a workplace plan	\$98,000 to \$118,000	\$99,000 to \$119,000
Married filing jointly when the contributor isn't covered by a workplace plan but the spouse is covered	\$184,000 to \$194,000	\$186,000 to \$196,000
Married and covered by a workplace plan but filing separately	\$0 to \$10,000	\$0 to \$10,000

Roth IRA income eligibility phaseout	2016	2017
Single and head of household filers	\$117,000 to \$132,000	\$118,000 to \$133,000
Married filing jointly or qualified widow/widowers	\$184,000 to \$194,000	\$186,000 to \$196,000
Married filing separately	\$0 to \$10,000	\$0 to \$10,000

Compounding money over time can be powerful



For those who qualify, a Roth IRA can be a very good planning tool. Among its many advantages, Roth IRAs allow your money to grow tax free and withdrawals are tax free as well.

Roth IRAs have rules and limitations; however, Roth IRAs may improve your tax picture. You contribute money that has already been taxed (after-tax dollars) to a Roth IRA. There's no tax deduction on the front end as there can be with a traditional IRA. Any growth or earnings from the investments in the account—and money you take out in retirement—is free from federal taxes with a few conditions. Typically, withdrawals from Roth IRAs are federal income tax free and penalty free if a five-year “aging” period has been met (if a withdrawal is made after a five-year period, beginning with the first taxable year after a contribution to any Roth IRA was made) and the account owner is age 59½ or older, disabled, or deceased.

Not everyone can contribute to a Roth IRA. There are income limitations on who can contribute to a Roth IRA. In 2017, eligibility to contribute to a Roth IRA for single filers in 2017 starts to phase out at \$118,000 and completely phases out at \$133,000.

Custodial Roth IRAs

Starting retirement savings early can allow you the potential advantage of growing money in a tax efficient account over a long period of time. Many children work before they reach age 18. The income they earn makes them eligible to contribute to a Roth IRA, which can be an extremely smart move for teenagers. This can also provide an excellent opportunity for you to teach or reinforce with your children the importance of saving money.

Historically, some financial institutions did not let minor children open a Roth IRA. Fortunately, some institutions will let parents act as a custodian on a custodial Roth IRA for the benefit of their children. Some of the rules regarding custodial Roth IRAs are:

- In order to be eligible to open a custodial Roth IRA, the child must meet all the same requirements as an adult would. The minor must have earned income, and

contributions are limited to the lesser of total earned income for the year and the current maximum set by law, which for 2016 and 2017 is \$5,500.

- Also, adjusted gross income for the child must be below the thresholds above which Roth IRAs aren't allowed.
- Even though the custodian is the legal owner of the account, the Roth IRA must be managed for the benefit of the minor child.
- As the custodian, you make the decisions on investment choices—as well as decisions on if, why, and when the money might be withdrawn—until your child reaches “adulthood,” defined by age (usually between 18 and 21, depending on your state of residence). Once they reach that age, the account will then need to be re-registered in their name and it becomes an ordinary Roth IRA.

If you're the parent of a child who has earned income, a Custodial IRA can be a great way to teach the value of saving and investing. Besides getting a head start on saving, your child may be able to use the funds for college expenses—or even to buy a first home.

There are several ways to make a Custodial Roth happen. For example, you can potentially use your annual ability to gift to children or grandchildren to make this happen. **If your child or grandchild is earning money, call us and we can discuss your options for setting up Custodial Roths.**

[Backdoor Roth IRAs:](#) **A Potential Way for High Income Earners to Participate in Roth IRAs**

The traditional contribution (“front door”) for Roth IRAs is currently not available for higher income earners. Married couples earning \$196,000 or more and singles earning \$133,000 or more in 2017 are still barred from contributing directly to Roth IRAs.

In 2010, Congress changed the rules and since then anyone can convert a traditional IRA to a Roth IRA. However, higher income earners are still ineligible to contribute to a Roth IRA. A Backdoor Roth IRA is a strategy for some higher income earners to participate in Roth IRAs. It is a way for higher income earners to put money into a traditional IRA and then roll that into a Roth IRA, getting all the benefits. While this strategy sounds simple, there are several rules that you must know and follow to make sure you do not incur unintended tax consequences. This is where working with a knowledgeable financial or tax professional can provide some great guidance and value.

One of the primary benefits of a Roth IRA is that any money contributed grows tax-free and can be withdrawn without any further income taxation. In addition, unlike a traditional IRA, Roth IRAs have no required lifetime minimum distributions. Another benefit of a Roth IRA is it can be passed on to your heirs income tax free. This allows your funds to grow and compound tax free over many years.

How Does the Backdoor Roth IRA Conversion Work?

The Backdoor Roth conversion consists of two simple steps:

- 1) You make a nondeductible contribution to your traditional IRA.
- 2) Then after consulting with your financial advisor or tax professional, you convert this IRA into a Roth IRA (potentially paying little to no taxes on the conversion).

There's one big caveat: This strategy works best tax-wise for people who don't already have money in traditional IRAs. That's because in conversions, earnings and previously untaxed contributions in traditional IRAs are taxed—and that tax is figured based on all your traditional IRAs, even ones you aren't converting (Please read the section on the Pro Rata Rule).

For an investor who doesn't already hold any traditional IRAs, creating one and then quickly converting it into a Roth IRA will incur little or no tax, because after a short holding period there's likely to be little or no appreciation or interest earned in the account. However, if you already have money in traditional deductible IRAs, you could face a far higher tax bill on the conversion (again, this is covered later in the section on the Pro Rata Rule).

If you choose to, you can contribute to a non-deductible IRA for 2017 (the maximum is \$5,500 or \$6,500 for those age 50 or older). Remember, you must contribute to your IRAs prior to the April 18, 2017 tax deadline. This non-deductible IRA can then be used for your backdoor Roth IRA conversion (please call us prior to doing so because the rules for Roth conversions can be complicated).

Example of a Backdoor Roth IRA

Jim, a high income earner, decides on January 2nd to put \$5,500 into a traditional IRA for himself and another \$5,500 into a traditional IRA for his wife Pam. Jim's income is too high to be able to deduct these contributions from his taxes. After consulting with his financial advisor or tax advisor, he then converts the traditional IRAs to Roth IRAs completely tax-free. His income is too high for him to make a direct contribution into a Roth IRA, but there's no income limit on conversions! Since Jim and Pam couldn't deduct the contribution anyway, they might as well get the advantage of never paying taxes on that money again available through the Roth IRA.

This is a hypothetical example and is not representative of any specific investment. Your results may vary.

Beware of the Pro Rata Rule for Roth Conversions

The Pro Rata rule for Roth conversions states that if you have any other deductible IRAs (i.e. a previous 401k that you've rolled over), the conversion of any contributions becomes a taxable event that you'll need to pay taxes on upfront.

The Pro Rata rule for Roth conversions determines whether or not your conversion will be taxable! For taxation purposes, the IRS will look at your entire IRA holdings (even if they are in different accounts), not just the traditional IRA you are converting to a Roth IRA, and will determine what your tax bill will be based upon a ratio of IRA assets that have already been taxed to those IRA assets in total.

The IRS determines the tax on this conversion based on the value of all of your IRA assets. For example Julia, a high income earner, already has \$94,500 in an IRA account, all of which has never been taxed. She decides on January 2nd to put \$5,500 into a new traditional IRA. The next day she converts the new traditional non-deductible IRA to a Roth IRA. Julia's income is too high for her to make a direct contribution into a Roth IRA, but there's no income limit on conversions. She has \$94,500 in other IRAs (previously non-taxed), so her total IRA assets are now \$100,000. When she converts \$5,500 to a Roth IRA, the IRS pro-rates her tax basis on the previous taxation of her total IRA assets, therefore making this conversion 94.5% taxable ($\$94,500 / \$100,000 = 94.5\%$).

This is a hypothetical example and is not representative of any specific investment. Your results may vary.

Julia's Backdoor Roth IRA Conversion			
Balance in All IRAs	Contribution to Non-deductible traditional IRA	Convert to Roth IRA	Income Subject to Taxation
\$94,500	\$5,500	\$5,500	\$4,750

So if you plan on using this backdoor IRA strategy, you want to be clear as to whether or not you have any other IRAs. As you can see, this can be a confusing area and this is where we can help. If you are a high income earner we would be happy to review your situation to determine if this strategy is in your best interest.

Also, please remember that your spouse's IRA is separate from yours.

Jim's Backdoor Roth IRA Conversion without Additional IRAs		
Contribution to Non-deductible traditional IRA	Convert to Roth IRA	Income Subject to Taxation
\$5,500	\$5,500	\$0

Am I a Candidate for a Backdoor Roth IRA?

Backdoor Roth IRAs can be appropriate for investors who:

- Only have retirement accounts through their jobs (i.e. 401k's) and want to increase their retirement savings in tax-advantaged accounts, but whose income is too high to qualify for standard Roth IRA contributions; and
- Have the time and ability to wait for five years or until they are 59 ½ to avoid the 10% penalty on early withdrawals.
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A Backdoor Roth IRA is probably *not* recommended if you:

- Are over the age of 70½ and can no longer contribute to a traditional IRA.
- Don't want to contribute more than the maximum retirement limit through your workplace retirement account.
- Already have money in a traditional IRA and because of the Pro Rata rule may end up in a non-tax advantageous position when converting to a Backdoor Roth IRA.
- Plan or expect to withdraw the funds in the Roth IRA within the first five years of opening it. A Backdoor Roth is considered a conversion and not a contribution. Therefore, the funds will incur a 10% penalty if withdrawn within five years unless you are age 59 ½ or older.
- Are in a high tax bracket now and expect to be in a lower tax bracket in the future.
- Plan to relocate to a lower or no income tax state.

Note: A Backdoor Roth IRA is a strategy that can be useful for the right investor. Currently, there are proposals to close down this opportunity. However, as of today, it is still available. While Backdoor Roth IRAs can be beneficial to many investors, they aren't for everyone. They come with their limitations and complications. There are precautions that need to be taken to reap the full benefits of any financial decision.

Conclusion

If you have an interest in further discussing funding your retirement plans, the custodial Roth IRA or a Backdoor Roth IRA, please call us. This is an area where a highly informed financial advisor can help you make an educated and calculated decision. As with all tax sensitive decisions, you should always consult with your financial advisor and tax professional to help avoid tax ramifications.

As always, we are here to help and can look at your specific financial situation and chart the right path for you. We enjoy the opportunity to assist clients in addressing all financial matters



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The Roth IRA offers tax deferral on any earnings in the account. Withdrawals from the account may be tax free, as long as they are considered qualified. Limitations and restrictions may apply. Withdrawals prior to age 59 ½ may result in a 10% IRS penalty tax. Future tax laws can change at any time and may impact the benefits of Roth IRAs. Their tax treatment may change. Roth IRA account owners should consider the potential tax ramifications, age and contribution limits in regards to funding a Roth IRA.

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