

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

Traditional and ROTH IRAs: Contributions and Distributions Revisited

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A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Individual retirement accounts or IRAs are one of the most powerful retirement savings tools available to individuals. They offer the opportunity to plan and save for future retirement needs, often with more flexibility and control than typical employer plans.

In fact, the IRS encourages taxpayers to contribute to these types of accounts by providing special tax incentives. In this issue , we will explore some of these rules and regulations in depth. The review seems timely, as a recent Tax Court case shed some light on the taxation of traditional IRA distributions.

Our hope is that financial professionals will come away from this issue with a greater knowledge and understanding of the rules and regulations that govern IRAs, in order to be better prepared to serve their clients.

Regards,
Michael W. Lagos, CFP®

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Traditional and ROTH IRAs: Contributions and Distributions Revisited

General Contribution Rules

In 2020 individuals with earned income are allowed to contribute up to \$6,000 per year into a traditional or Roth IRA. If the individual is age 50 or older, the contribution limit is increased by \$1,000. This limit applies in the aggregate to contributions to any traditional or Roth IRA the taxpayer owns. The taxpayer cannot contribute \$6,000 to a traditional and another \$6,000 to a Roth IRA in the same year.

Contribution amounts are adjusted from time to time because of inflation. The 2019 and 2020 limits are the same.

The due date for IRA contributions is the taxpayer's tax return deadline, generally April 15. For tax year 2019, the deadline to make traditional and Roth IRA contributions has been delayed until July 15, 2020.

EARNED INCOME REQUIREMENT

To contribute to a traditional or Roth IRA, the taxpayer or his spouse must have earned income. The maximum contribution a taxpayer can make for a calendar year is equal to the lesser of the general contribution limit or the taxpayer's earned income.

What counts as earned income? The IRS gives the following examples of earned income in Tax Topic 451:

- wages,
- salaries,
- commissions,
- tips,
- bonuses, or
- net income from self-employment.

It goes on to list things that *do not count* as earned income such as earnings and profits from real property such as rental income, interest and dividend income, or any amount received as pension or annuity income, or as deferred compensation.

IRS Code Sections 408, 179, and 1402, examined together, indicate that earned income must generally be included in the gross income of the taxpayer to count as eligible earned income for traditional or Roth IRA contributions. In most cases, the way to identify income as earned is to check whether the taxpayer paid FICA taxes on it.

SPOUSAL CONTRIBUTION

The IRS allows a married couple filing jointly to make IRA contributions for one spouse who has little or no earned income if the spouse with greater income has enough to support an IRA contribution for the other spouse.

For example, say that Harry (35) and Sally (33) are a married couple. Sally is the primary breadwinner. Harry stays at home with the couple's children. Sally brings home \$95,000 a year from her job. She can make a full IRA contribution for herself as well as for Harry.

If Sally only made \$10,000 at her job, she could possibly make the maximum \$6,000 contribution for herself. If she did so, she could only make a \$4,000 contribution for Harry.

PENALTY FOR EXCESS CONTRIBUTIONS

What are the consequences if a taxpayer puts more money into an IRA than she is entitled to contribute?

The IRS refers to too much portion as an excess contribution. If the taxpayer fails to make any corrective steps, the excess contribution will be subject to a 6 percent penalty tax. The penalty for excess IRA contributions is not a one-time penalty. It will apply every year the excess funds remain in the IRA.

It is possible for the taxpayer to correct the excess contribution by withdrawing the extra, along with any earnings associated with it, by the due date for the return of the year. For most years this would be April 15. For tax year 2019, the deadline to fix an excess contribution is July 15, 2020. The withdrawn principal will not be included in the taxpayer's income, but the earning will be.

If the taxpayer fails to make a corrective distribution by the due date of the tax return, she should still remove the excess as soon as possible. The IRS expects the taxpayer to file Form 5329 to report and pay the penalty tax due in connection with the excess contribution. If the person continues to fail to remove the excess, she will have to repeat this process each year the excess funds remain in the account.

It is possible to apply an excess contribution from an earlier year to the current year without taking a distribution. This method allows the taxpayer to avoid making a distribution, but it does not avoid the 6 percent tax on excess contributions remaining at the end of the year and reduces the maximum contribution for the current year.

Here's an example, adapted from IRS Publication 590:

Teri was entitled to contribute to her traditional IRA and deduct \$1,000 in 2018 and \$1,500 in 2019 (the amounts of her taxable compensation for these years). For 2018, she actually contributed \$1,400 but could deduct only \$1,000. In 2018, \$400 is an excess contribution subject to the 6% tax. However, she wouldn't have to pay the 6% tax if she withdrew the excess (including any earnings) before the due date of her 2018 return. Because Teri didn't withdraw the excess, she owes excise tax of \$24 for 2018. To avoid the excise tax for 2019, she can correct the \$400 excess amount from 2018 in 2019 if her actual contributions are only \$1,100 for 2019 (the allowable deductible contribution of \$1,500 minus the \$400 excess from 2018 she wants to treat as a deductible contribution in 2019). Teri can deduct \$1,500 in 2019 (the \$1,100 actually contributed plus the \$400 excess contribution from 2018).

ROTH IRAs

Roth IRAs can be powerful savings tools. Contributions to Roth IRAs are never tax deductible, but Roth IRAs offer a different type of incentive. Taxpayers favor Roth IRAs because of the tax-favored treatment of distributions.

If the taxpayer's initial funding of a Roth IRA is aged by five years and if the taxpayer is older than 59 ½, all distributions from any of the taxpayer's Roth IRA are income tax free.

Income Limits for Roth IRA Contributions

Taxpayers who have too much modified adjusted gross income (MAGI) are not eligible to make contributions to a Roth IRA. For most taxpayers, MAGI is adjusted gross income minus deductions for traditional IRA contributions, and also minus any deductions for student loan interest or tuition.

How much is too much MAGI?

In 2020 married filing jointly taxpayers whose MAGI is at or below \$196,000 can make a full contribution to their Roth IRA. If their MAGI exceeds \$206,000, they cannot make a Roth IRA contribution. The amount of the contribution is phased out between \$196,000 and \$206,000. The 2019 thresholds are \$193,000 and \$203,000.

In 2020 a single or head of household filer whose MAGI is at or below \$124,000 can make a full contribution to her Roth IRA. If her MAGI exceeds \$139,000, she is ineligible to make a Roth IRA contribution. If her MAGI is between \$124,000 and \$139,000, the amount of her contribution is phased out. The 2019 thresholds are \$122,000 and \$137,000.

If the taxpayer is married filing separately and the taxpayer and her spouse lived together at any point during the year and MAGI exceeds \$10,000, she is ineligible to make a Roth IRA contribution.

If the taxpayers did not live together at any point during the tax year, the taxpayer can use the single filer thresholds.

TRADITIONAL IRAs

Age No Longer a Limitation

In December 2019 the President signed the Setting Every Community Up for Retirement Act, also known as the SECURE Act into law. This Act included one major change for traditional IRA contributions.

Prior to the SECURE Act, taxpayers were no longer eligible to contribute to a traditional IRA as of the year they attained age 70 ½. The SECURE Act removed the age-based contribution restriction beginning with tax year 2020.

Deductible IRA Contributions

Several factors should be considered when making an IRA contribution. One of the biggest considerations for many taxpayers is whether a contribution may be deducted. If the taxpayer is not eligible to make a deductible IRA contribution, she may be eligible to make a Roth IRA contribution. If she is not eligible for either a deductible traditional IRA contribution or a Roth IRA contribution, she may still make a contribution to a traditional IRA that is not deductible if she is otherwise eligible.

The ability of the taxpayer to deduct traditional IRA contributions depends on the taxpayer's status as a participant in a qualified plan, her MAGI, and her filing status.

Active Participant

Every year the IRS sets income limits that apply to deductible IRA contributions. The income limits differ depending on how taxpayers file their taxes and whether the taxpayer—or the taxpayer's spouse—is an active participant in a retirement plan.

Who is an active participant? The definition depends on the type of pension plan available to the taxpayer and the details of any contributions for the year:

- If the taxpayer is eligible to participate in a *401K* or *403b plan* but no employee deferrals or employer contributions were made to the plan in a calendar year, the taxpayer is not an active participant. However, any employer or employee contributions, even if tiny, would make the person an active participant.
- If the taxpayer is eligible to participate in a *defined benefit pension plan*, the taxpayer is always an active participant.
- If the employer makes a contribution on the taxpayer's behalf into a *target benefit* or *money purchase plan* for the tax year in question, the taxpayer is an active participant for that year.
- If the taxpayer is eligible to participate in a *SEP IRA* or *profit-sharing plan* but the employer makes no contributions to the plan for a given tax year, the taxpayer is not an active participant for that year.

- Participants in a Section 457(b) plan sponsored by a governmental agency or nonprofit organization are not considered active participants in a pension plan.

Income Limits for Active Employees

For tax year 2020, single taxpayers filing as head of household who are covered by a qualified plan at work may make a fully deductible IRA contribution if MAGI is at or below \$65,000. If

MAGI exceeds \$75,000, those taxpayers cannot make deductible traditional IRA contributions.

When the income of single head of household taxpayers fall between \$65,000 and \$75,000, the amount of the deductible contribution is phased out. The 2019 phaseout is between \$64,000 and \$74,000.

Where both spouses are active participants in a plan and file jointly in 2020, both may make a fully deductible IRA contribution if their MAGI is at or below \$104,000. If their income exceeds \$124,000, they are not eligible to make a deductible IRA contribution. When their income falls between \$104,000 and \$124,000, the amount of the deductible contribution is reduced. The 2019 phaseout range is between \$103,000 and \$123,000.

If the taxpayers' status is married filing separately, and if the taxpayers live together, the MAGI limits are greatly reduced. The phaseout begins at zero, and the taxpayers' ability to make a deductible IRA contribution is completely phased out when their MAGI reaches \$10,000.

If the taxpayers are married filing separately and did not live together at any point during the tax year, the limits are determined using the single-filer status numbers.

Income Limits Where One Spouse Is an Active Employee

If one spouse of a married filing jointly couple is an active employee and the other is not, the MAGI limits are different for each spouse. The spouse that is an active employee will use the MAGI limits given above for active participants. The spouse that is not an active employee will have a higher threshold.

In 2020 the non-active spouse will be able to make a fully deductible IRA contribution if the couple's MAGI is at or below \$196,000. If the couple's MAGI exceeds \$206,000, neither is eligible for a deductible IRA contribution. The deductible amount is phased out between \$196,000 and \$206,000. For tax year 2019 the phaseout is between \$193,000 and \$203,000.

No Income Limit for Nonparticipant Taxpayers

If a single taxpayer is not an active participant in a qualified plan and is otherwise eligible to make an IRA contribution, he may deduct his IRA contribution regardless of MAGI. If neither spouse in a married filing jointly couple is an active participant in a qualified plan, both spouses may make deductible IRA contributions as long as they are otherwise eligible, regardless of MAGI.

Nondeductible Traditional IRA Contributions

What if a taxpayer makes too much money to make a deductible IRA contribution or make a Roth IRA contribution? He can potentially contribute to a nondeductible traditional IRA.

As long as taxpayers have earned income, they are eligible to contribute to a nondeductible traditional IRA. The contribution amount is still limited to the yearly contribution limits set by the IRS for IRAs. A taxpayer who is an active participant in a qualified plan and earns a billion dollars a year is eligible to make a nondeductible IRA contribution.

TRACKING BASIS

When a person has made nondeductible contributions to a traditional IRA, the taxpayer must keep track of the basis so that future distributions are taxed properly. Distributions of nondeductible IRA contributions are received income tax free. Because of that, it is important for taxpayers to correctly track and report those contributions to the IRS.

How do taxpayers report to the IRS that their IRA has nondeductible IRA contributions? According to IRS Publication 590-A, a taxpayer must file Form 8606 each year that nondeductible IRA contributions are made.

Pro-Rata Rule

Taxpayers are not allowed to isolate and withdraw only the after-tax portion of an IRA. Internal Revenue Code Section 72(e)(8) says that any distribution taken will reflect the ratio of pre-tax to after-tax funds within the account.

In addition, the IRS applies the aggregation rule found in IRC Section 408(d)(2) to IRAs so that all IRAs are generally treated as one. The IRS effectively treats all traditional IRAs (including SEPs and SIMPLE IRAs) as one bucket of money and all Roth IRAs as one bucket of money, regardless of how many different IRA accounts a taxpayer may have.

The aggregation rule can make tracking basis and correctly reporting taxable distributions even more complicated than simply tracking basis in an individual account.

Two examples may help clarify these rules.

Example 1: Harry has a traditional IRA. In the past he has made deductible traditional IRA contributions, but this year he is ineligible to do so, even though he has earned income. He decides to make a nondeductible \$5,000 contribution to his traditional IRA. His IRA now totals \$100,000.

Harry decides to take a \$5,000 distribution. By rule, the distribution consists of both pre-tax and after-tax amounts. Approximately 5 percent or \$250 of the distribution would come from the after-tax amount. We arrive at this total by dividing the after-tax amount by the total ($5,000/100,000 = .05$) and then multiplying the percentage by the distribution ($5,000 \times .05 = 250$).

Example 2: Harry has two pre-tax IRA accounts. Account A has \$25,000 and account B has \$70,000. Harry also has a third IRA, account C, that contains his new after-tax contribution of \$5,000. The total of all three of Harry's IRAs is \$100,000.

If Harry takes the full \$5,000 from account C, the tax result is the same as in Example 1 above. The distribution will contain both pre-tax and after-tax funds because of the aggregation rule. Approximately \$250 of the distribution will come from after-tax contributions, even though the distribution itself was taken from the account that only contained after-tax contributions.

The pro-rata rule and the aggregation rules can be confusing, highlighting the need for proper record keeping and reporting.

THE SHANK CASE

What if a taxpayer fails to file Form 8606? The short answer is that taxpayers can expect scrutiny from the IRS if they take an IRA distribution and fail to report the whole amount as taxable.

In the case of *Andrew G. Shank v. Commission of Internal Revenue*, a taxpayer found out the hard way that reporting nondeductible IRA contributions is important to prevent a fight with the IRS. In 2014 Shank liquidated an IRA account and failed to report the distribution as taxable on his return. The IRS came calling later. Here's the story.

In the late 1990s Shank established an IRA. The taxpayer failed to save any tax or business records from this time. He did have evidence that he was a high wage earner and was covered by his employer's retirement plan, implying that he wouldn't have been able to make a deductible IRA contribution during this time. Over the years the taxpayer moved the IRA to several different institutions but failed to keep much documentation about his IRA account.

In 2014 he withdrew the whole balance of his IRA, receiving a distribution of \$27,745. The 1099-R he received reported that the distribution was a regular distribution but that the taxable amount of the distribution was not determined. The documentation that accompanied the 1099-R stated that it was the taxpayer's responsibility to determine and report the taxable amount to the IRS.

The taxpayer timely filed his 2014 tax return but failed to report any taxable distribution from the IRA. In March 2016 the IRS issued a notice of deficiency, determining that the entire distribution was taxable because Shank failed to establish basis. Shank fought the notice, and the case ended up in Tax Court.

Shank was able to produce an account summary from Citibank, one of the institutions that had held his IRA during the ensuing years. The statement was from 2006, and it showed that the account assets were initially purchased sometime before June 1998 for \$4,760. The statement showed no other contributions. The court was able to obtain several records from the IRS from the intervening years and found no other proof of contributions. The court was also able to establish that the IRA was not a Roth IRA.

The court was fairly lenient on the lack of evidence given the amount of time that had passed from the initial funding of the IRA. The court relied on the Citibank statement, finding that \$4,760 of the distribution was basis, and the remaining \$22,985 consisted of taxable gains.

This case may seem like a win for the taxpayer, but when one considers the cost of the litigation and the size of the account, it can hardly be said that the taxpayer really won. If the taxpayer had correctly filed Form 8606, the fight with the Service could have probably been avoided.

BACKDOOR ROTH STRATEGY

The backdoor Roth strategy, if implemented correctly, allows a high wage earner not otherwise eligible to contribute to a Roth IRA to effectively do just that, by converting a nondeductible IRA contribution to a Roth IRA.

As mentioned earlier, if a married filing joint couple has a MAGI that exceeds \$206,000 or an individual filer's MAGI exceeds \$139,000, they are ineligible to contribute to a Roth IRA. However, anyone with earned income can contribute to a nondeductible traditional IRA regardless of her MAGI or whether or not she is an active participant in a retirement plan.

How does a taxpayer use a nondeductible IRA to make a backdoor Roth IRA contribution? High wage earners first make the nondeductible contribution to their traditional IRA. After a reasonable amount of time, taxpayers convert the nondeductible IRA to a Roth IRA. When taxpayers perform a Roth conversion, the pre-tax amount that is being converted is included in their taxable income. When appropriately implemented, taxpayers will only pay taxes on any growth associated with the initial nondeductible IRA contribution.

Taxpayers could potentially take advantage of this strategy year after year under current tax rules.

The strategy seems easy enough, but remember those pesky pro-rata and aggregation rules we mentioned earlier? Those rules have to be considered when implementing this strategy. Here are two examples.

Example 1: Lloyd is a high wage earner. He is a single filer, and his MAGI for 2020 will exceed \$139,000. He would like to contribute to a Roth IRA. He has no other IRA accounts. He makes a \$6,000 contribution to a nondeductible IRA. After several months the value of the account is \$6,250. He then converts the whole \$6,250. When he files his taxes for 2020, he will report the nondeductible traditional IRA on Form 8606 as well as the conversion. Because he has properly reported his after-tax contribution, he will only be liable for tax on the \$250 gain.

Example 2: Same facts as above, but Lloyd does have two other pre-tax IRA accounts. IRA A contains \$63,000. IRA B contains \$30,750. Lloyd makes his contribution to a new IRA, IRA C, hoping he can isolate the nondeductible contribution and only convert it. He now has IRA C with a balance of \$6,000. Lloyd converts IRA C. At the time of the conversion, IRA C has a value of \$6,250. He correctly reports the after-tax contribution on Form 8606. He tries to claim that he only owes tax on the \$250 worth of growth in IRA C. The IRS does not agree. They apply the aggregation and pro-rata rules and find that of the amount Lloyd converted only \$375 is after-tax making the remaining \$5,860 of the conversion taxable. At the time of Lloyd's conversion, his IRA accounts totaled \$100,000. He had an after-tax contribution of \$6,000. The pro-rata rule calculation is as follows $\$6,000/\$100,000 = .06$, or 6 percent.

To determine the basis included in the conversion, we take that percentage and multiply it by the converted amount $.06 \times 6,250 = 375$. Of the \$6,250 Lloyd converted, only \$375 is considered to have come from his after-tax contribution. The remaining \$5,875 is taxable.

Is there anything Lloyd could have done to avoid the result in Example 2? Possibly, if Lloyd had an employer plan that accepted rollovers. By rule, a taxpayer may only roll pre-tax IRA money into an employer plan. Any rollover from an IRA to an employer plan drains the pre-tax money first. Rolling all the pre-tax IRA money into a plan, such as a 401k or 403b, would work to isolate the remaining after-tax funds in the IRA. If only the after-tax money is left in the IRA, a Roth conversion of those funds would not generate a taxable result.

When is the pro-rata determination made with regard to IRA accounts? IRC Section 408(d)(2)(C) says that the pro-rata and aggregation rules are applied based on the account values at the *end of the taxable year* in which a distribution or conversion is made.

The backdoor Roth strategy can be a powerful tool for high-income wage earners, but the strategy can lead to unexpected results if the taxpayer is not aware of all of the rules. If you have a client considering the strategy, familiarize yourself with these rules to avoid unwanted tax surprises.

CONCLUSION

IRAs are great retirement planning tools. They can offer more convenience, flexibility, and control than an employer-sponsored retirement plan. They also offer an array of tax advantages, whether they are deductible, nondeductible, or Roth IRAs.

Some taxpayers are drawn to the deduction they may get for contributing to an IRA. The deductibility of a traditional IRA contribution may be important to those clients and prospects. Other taxpayers may like the idea of having qualified tax-free distributions from a Roth IRA. Clients in either category also enjoy the tax-deferred growth that any IRA offers.

The advantages of saving in IRAs may seem like a no-brainer for some. Unfortunately, the IRA rules are not always so easy to understand, especially for a layperson. Fortunately, our clients have the benefit of working with financial professionals who can help them sort out the complexities.

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