DUNCAN & HALEY LTD

Roth IRA and 401(k)

What is a Roth account? A Roth IRA or Roth 401(k) is a retirement account that offers a valuable future tax break: tax-free income in retirement. Specifically, deposits to a Roth account are made after tax now, and any withdrawals from a Roth are tax free, even the investment gains, as long as they satisfy the later of 5 years or age 59.5 (whichever is later after first deposit) requirement. This is the exact opposite of the most common type of retirement plan contribution: the pre-tax contribution, where contributions are made pre-tax now and are then taxed upon withdrawal during retirement.

What's the difference between a Roth 401(k) and a Roth IRA? The major difference between a Roth 401(k) and Roth IRA is that Roth IRA's are subject to income limitations for a person to be eligible to make contributions, wheras the Roth 401(k) has no such limit. The annual contributions limits are also lower for Roth IRA's than 401(k) contributions limits. They are separate from a limit perspective. A person could conceivably make a Roth 401(k) and in addition a Roth IRA contribution assuming they aren't disqualified from the Roth IRA due to income.

There are two basic methods generally available to create Roth funds in your IRA or 401(k). First, you can make contributions through payroll into a Roth 401(k) that may be available through your employer, and/or as new contributions to a Roth IRA as described above. You can also complete a Roth conversion, where you effectively convert vested pre-tax funds over into a Roth account. The financial institution holding the pre-tax account issues a 1099-R to you and the IRS at year-end reporting the income for any amount converted, which you will then pay income tax on at whatever rate is required based on your total income for the year. There is no limit to the amount you can convert each year and conversion amounts do not reduce contribution limits.

When is it a good idea to accumulate Roth funds? We generally feel most everyone will want at least a small portion of their overall retirement assets to be Roth, even in the event they expect to be in a lower tax bracket during most of their retirement years. The reason is that there are always those surprise, unusual expenses during retirement (e.g. new car, new roof, medical expenses, etc.), and if a retiree doesn't have a Roth account to use, depending on how close they are to the next tax bracket, use of extra pre-tax funds may be taxed a higher rate. Roth funds, on the other hand, allow a person to access money in retirement without getting thrown into the next tax bracket.

Here are some examples of when making Roth contributions or completing a Roth conversion can make sense:

- **You have unusually low income for the short term –** For any number of reasons a person could have a lower income than normal in a given year (for example, someone recently retired or between jobs, or a person taking a pay cut for business purposes). Lower income means a lower tax bracket and there may be room to realize income before a higher rate of tax kicks in. See page 3 for a summary of the 2020 income tax rates.

  If a person is able to receive more income (i.e. the amount converted to Roth) and still remain in a lower tax bracket, then a conversion to take advantage of that lower bracket, could be beneficial, especially if that person expects higher income in the future. Please see the tax tables on page 3 to determine your current, incremental tax rate.

- **High income now, with an expectation for continued high income in retirement –** Due to the large budget deficit the US Government is now running, many expect tax rates to be much higher in the future, especially for those reaching the 33% bracket and up. We sense that 33% or 35% might seem like a very low rate of tax down the road. Most tax increases are expected to be carried by those earning over $200,000 annually. Therefore, if you fall into this camp, a conversion could be a smart move in order to take advantage of today's "low" tax rates.

- **Low reliance on retirement plan assets for retirement living expenses –** For those who have other sources of retirement income and do not expect to tap much, if any, of their retirement plan balances during retirement, then a Roth conversion could make good sense. Pre-tax IRA's and retirement accounts are subject to the Required Minimum Distribution (RMD) rules, where a person is required to begin withdrawals (and

pay tax) at age 72, at the latest. A Roth IRA has no such requirement, and passes income tax free to heirs. Note that "estate taxes" may still apply.

- **Currently maxing out contributions with the desire to save more –** If a person is currently maximizing their pre-tax contributions, then they can effectively raise their limit by making all or a portion of their contributions of the Roth variety. Because Roth contributions are after tax now with tax-free payouts later, the tax due is not included in the limit. Put another way, $18,000 as a Roth contribution is worth a lot more than $18,000 as pre-tax, because the tax that will someday be due is included in the pre-tax contribution.

- **Taking advantage of market declines.** During market corrections, Roth conversions and contributions can be helpful. For a conversion, assuming reduced account values are temporary, then in essence the investor receives, a discount on the tax cost for completing a conversion. For example, if an S&P 500 fund was worth $10,000 at the previous market peak and a person completed a conversion then, they would pay tax on $10,000 worth of income. However, if the market "corrected" and the fund was worth only $7,000when the conversion occurs, then the investor pays tax on income of only $7,000. There's a bit of a timing element in this, however, it's a way to make lemonade out of lemons in a down market. The recovery in value that should ensue after the conversion then becomes tax free gains through the Roth rules. Please note that the tax cost for Roth conversions are generally advised and/or required to be paid with outside funds. Additional withdrawals from a retirement account to pay the tax cost are either not allowed or are subjected to the 10% penalty when they are allowed.

2020 federal income tax brackets

2020 tax brackets (for taxes due April 15, 2021)

TAX RATE	SINGLE	HEAD OF HOUSEHOLD	MARRIED FILING JOINTLY OR QUALIFYING WIDOW	MARRIED FILING SEPARATELY
10%	$0 to $9,875	$0 to $14,100	$0 to $19,750	$0 to $9,875
12%	$9,876 to $40,125	$14,101 to $53,700	$19,751 to $80,250	$9,876 to $40,125
22%	$40,126 to $85,525	$53,701 to $85,500	$80,251 to $171,050	$40,126 to $85,525
24%	$85,526 to $163,300	$85,501 to $163,300	$171,051 to $326,600	$85,526 to $163,300
32%	$163,301 to $207,350	$163,301 to $207,350	$326,601 to $414,700	$163,301 to $207,350
35%	$207,351 to $518,400	$207,351 to $518,400	$414,701 to $622,050	$207,351 to $311,025
37%	$518,401 or more	$518,401 or more	$622,051 or more	$311,026 or more

Tax rate source: www.irs.gov