

Using IRAs in tax planning during retirement

TAX: Because of the flexibility of IRA distributions, it's easy to move income among years.

By Richard Malamud, CPA, J.D., LL.M., and Tim Hilger, CPA

Those of us who are age 59½ and older and still working face some interesting decisions. After decades of hearing the mantra, “Defer, Defer, and then Defer” maybe it is time to change that to “Accelerate” — at least sometimes. It is the thing to do if you assume tax rates will not be going down and the future may bring us large capital gains or other income that could cause us to owe the new Medicare tax.

If we have a decent-sized IRA account, we can accelerate income anytime regardless of our age, except that those under age 59½ will owe an additional 10% penalty that can only be avoided by either rolling the distribution into a Roth or rolling it back into the traditional IRA within 60 days. That is where the planning occurs.

These considerations might be especially important for early retirees who haven't yet started drawing Social Security benefits and want to accelerate income into current years to avoid those benefits being taxable, or for mid-60s retirees who want to accelerate income before income is forced on them by RMD.

New taxes and increased rates

Starting this year, we face the potential increase in tax rates due to the Affordable Care Act's (ACA's) Medicare surtax of 3.8% on investment income, as well as the possible non-ACA tax rate increase for long-term capital gains from 15% to 20% if income exceeds certain levels (see box). In addition, there is a phaseout of the itemized deduction and personal exemptions. Don't forget that if your client has municipal bond income, he or she may generate the 3.8% Medicare surtax even though AGI is under \$200,000, as *modified* AGI is used to determine if the other investment income is subject to the tax.

| Potential new rates | | |
|---|-----------|-----------|
| | Single | Married |
| 20% capital gains rates start at ¹ | \$400,000 | \$450,000 |
| 3.8% investment tax ² | \$200,000 | \$250,000 |
| Exemption phaseout | \$250,000 | \$300,000 |

Finally, the income tax rates go above 28% at \$87,850 (single) and \$146,400 (married).

The question is, therefore, if taxable income or AGI is under any of these amounts, and it is likely that in the future income will be taxed above 28%, shouldn't income be accelerated to at least get up to the maximum amount taxed at 28% annually (\$87,850 or \$146,400)? It's like a reversal of a concept us older taxpayers remember: income averaging. By maximizing one's income so that the maximum amount is taxed at 28% each year, less income will be taxed in the future at a higher possible rate.

IRA distributions

Most income is inflexible in terms of when it is received. However, taxpayers, especially those over age 59½, have a great deal of flexibility with their IRAs. With only minor limitations, they can take distributions in any amount in any year. Moreover, by using the 60-day rollover rules

and Roth conversions, they can achieve even greater flexibility.

Maximizing current income at the 28% rate can be accomplished each year by making a taxable IRA distribution. The planning issue is how to determine the proper IRA distribution needed each year, because we all know that year-end tax projections are an art and not a science, especially for clients with mutual funds or partnerships.

The answer is, who cares? Simply do the best you can and make a sufficient worst-case scenario IRA distribution (not a direct rollover to the Roth), but do it in late December, possibly on December 30. Then the fun begins.

The tax return has to be “finalized” in less than 60 days so that the exact amount of income can be determined and the excess distribution can be rolled back to the IRA by the 60th day following the original distribution. (As a side benefit, isn’t it great that the client is now forced to give their tax data to you by early February?)

Suppose you took a \$30,000 IRA distribution in December because your salary was \$170,000 and your investment income was \$10,000, for “tentative AGI” of \$210,000. Assume your goal was \$200,000 of AGI or below. Assume, too, that the W-2 had Social Security wages of \$170,000 but taxable income of only \$166,000. When the return is prepared in mid-February, the actual income without regard to the IRA distribution is \$176,000. What do you do? Roll \$24,000, which is therefore taxable, into the Roth (or not) and \$6,000 back into the IRA, which is therefore not taxable. You have \$200,000 AGI and no 3.8% tax.

The Roth conversion

An even more powerful tool is the Roth conversion. Why? Because you get an even longer period of time to undo it (“recharacterize” it). With a conversion, the deadline to undo isn’t until the extended deadline of the tax return for the year of the conversion.³ This means the taxpayer doesn’t have to wait until late in the year to take a distribution and doesn’t have to decide within 60 days of the distribution.

Assume in the earlier example that the taxpayer had done a \$30,000 conversion rather than a \$30,000 distribution. The taxpayer could allow \$24,000 of the conversion to go through and recharacterize \$6,000 of the conversion back to the traditional IRA.

About the author

Richard Malamud is a professor in the Department of Accounting and Finance at California State University Dominguez Hills, where he teaches federal income tax law. You may reach him at (310) 243-2239 or rmalamud@csudh.edu.



¹ IRC §1(h)

² IRC §3101

³ Ann. 99-57

Cash balance plans gaining in popularity

RETIREMENT: A hybrid defined benefit plan has many of the characteristics and advantages of defined contribution plans.

By Tim Hilger, CPA

Editor

Just as large businesses have done in recent years, some smaller employers are starting to pay attention to cash balance plans.

They are increasingly popular for several reasons. Large businesses have converted from the