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Traditional IRA account owners have considerations to make before performing a Roth IRA conversion. These primarily include income tax consequences on the converted amount in the year of conversion, withdrawal limitations from a Roth IRA, and income limitations for future contributions to a Roth IRA. In addition, if you are required to take a required minimum distribution (RMD) in the year you convert, you must do so before converting to a Roth IRA.

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Keeping More of what You Earn: Taxation on Investments & Cash Flow

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Q: How are investment account earnings taxed?

A: Not only can retirement income be taxed at different rates, but it can also be taxed using different tax tables, and in some cases, not taxed at all. In addition, some “penalties” may apply if investor’s income reaches certain thresholds. Proper tax planning should be included when you work with your financial planner to potentially avoid these pitfalls and to attempt to maximize your after-tax returns.

Since income from investments themselves do not dictate your tax liability, how are taxes determined? Your tax liability on investment income is dependent on what type of account those investments are in so let’s begin by broadly separating account types into two categories: Taxable and Tax-advantaged.

Taxable accounts do not have preferential tax benefits. They are funded with after-tax dollars, and generally have less restrictions on accessing your money when compared to tax-advantaged accounts. Common registration types for taxable accounts include Individual accounts, Joint accounts, and Trusts. Taxes are due on paid out capital gains, interest, and dividends in the year that they occur. Interest, short-term capital gains (Positions that have been sold and held for less than one year), and non-qualified dividends are taxed as ordinary income according to federal income tax brackets. Long-term capital gains and qualified dividends are taxed at more favorable rates of 0%, 15%, or 20% depending on your reported adjusted gross income for the year. In addition, you may have an additional 3.8% Medicare surtax if you exceed certain income thresholds.

Tax-advantaged accounts are either tax-deferred or tax-exempt. Tax-deferred means that you will not pay taxes until you withdraw the money.

Common tax-deferred vehicles are 401(k)s, 403(b)s, and traditional IRAs. These accounts are designed to give you a tax deduction upfront on your contributions, and delay taxation until you take out the money in the future (hopefully in retirement at a lower tax rate). Tax-deferred accounts typically have a penalty if you take withdrawals before the age of 59.5. In addition, most tax-deferred accounts require that you satisfy a required minimum distribution (RMD) once you turn age 72. Roth IRAs and Roth 401(k)s are examples of tax-exempt accounts and municipal bonds are tax-exempt investments. Contributions are made with after-tax contributions. Investment gains are tax-deferred, and tax-exempt if your withdrawal is considered qualified. A qualified Roth withdrawal means that your initial contribution took place at least 5 years ago, or you have obtained the age of 59.5 (whichever is longer).

Example: Karla referred to all of her accounts as 401(k)s. Of her five accounts, she did not actually own a 401(k). It's not uncommon for investors to refer to their accounts by the wrong registration type; it can be confusing! If you are not familiar with how your retirement income is or will be taxed, it makes sense to work with a financial professional, as taxes can eat up as much as 2% per year [1].

Q: How are inherited assets taxed?

A: The tax liability depends on what type of asset you inherited, and potentially what state that you live in.

When you inherit ***taxable assets*** in a Community Property state, you are entitled to a full step-up in cost basis in most cases. The cost basis (or what was paid for the asset plus reinvested earnings), receives a step-up to its current market value on either the date of death or nine months later. This eliminates the unrealized capital gain that occurred between the original purchase the decedent's date of death.

Example: Sue inherits taxable accounts worth $1,000,000 on the date of her husband's death with a built-up gain of $500,000. Nine months later, the assets were worth $900,000. Sue can still step-up her cost basis to the value as of her husband's death (the $1,000,000) and now sell those assets to create a $100,000 tax loss.

Inheriting ***tax-advantaged accounts*** are very different. There is not a step-up in basis involved in tax-advantaged accounts. You, as the beneficiary, have a decision to make as to how to handle these assets. This is a very important decision because it will be a one-time decision that could have significant tax implications.

Example: Consider the spousal beneficiary options with a 401(k):

1. Remain in the 401k as a spousal beneficiary. This option keeps the account growing tax-deferred and eliminates the 10% early withdrawal penalty on withdrawals if you are under 59.5. You may have required minimum distributions based on your spouse's age.
2. Rollover the account into an inherited IRA. This keeps the money tax-deferred and preserves the inherited status so there will not be an early withdrawal penalty on withdrawals. This option could be favorable versus keeping the money in a 401(k) if your spouse was older than you because you can delay required minimum distributions until you reach age 72. If you are over 59.5, or confident that you will not need a withdrawal until age 59.5, you can rollover to an IRA in your name (without the inherited designation).
3. Roll the account into an existing employer sponsored retirement plan (e.g., your 401(k) plan). Rollover eligibility will be determined by the receiving plan. This option may allow you to borrow funds via a loan. Also keep in mind that you will lose the inherited status, so withdrawals may be subject to the 10% early withdrawal penalty if you are under the age of 59.5.
4. Cash out the account and pay the taxes. Cashing out will be considered ordinary income to you and may include a 10% penalty if you are under age 59 1/2. This typically makes sense only if you need all the money immediately.

Another common inheritance is ***life insurance***. Inheriting life insurance is income tax-free to you. However, if the decedent's estate eclipses the unified estate and gift tax credit amount, there may be estate taxes due.

Q: What should I do If I don't need my Required Minimum Distributions (RMDs)?

A: If you are in the favorable situation of not needing your required minimum distributions to live on, there are a few solutions that could potentially positively impact your overall financial situation, as normally, your RMD would be completely taxable.

1. Consider a Qualified Charitable Distribution (QCD). If are charitably inclined, a QCD can satisfy all or a portion of your required minimum distribution. Not only would you be giving to charity, a QCD excludes the donated amount from taxable income.
2. Consider converting pre-tax money to a Roth. The amount of the conversion would be taxable but could then potentially grow tax-free. Roth assets are not subject to RMDs, so ultimately you will reduce the amount that is required to come out in the future.
3. Consider reinvesting any excess RMD. If you withdraw your RMD and determine that you don't need all or a portion of the money, invest that money in a vehicle that has higher growth potential than your checking/savings account. This assumes that you already have an emergency fund and all short-term expenses covered in order to invest in a longer-term investment.

Example: Mary always used cash when donating to her church. Last year, she used the calculated RMD amount as a QCD from her IRA. This freed up additional cash in her savings, satisfied her RMD, and allowed her to donate using IRA money without tax implications

Q: How does my taxable income affect my Medicare Insurance premiums?

A: Your modified Adjusted Gross Income (AGI) affects how much you pay for Medicare Part B and prescription drug coverage. The standard Part B premium for 2021 is $148.50 but can be as high as $504.90 for high income earners. If you are single, and have a modified AGI above $88,000, you will be paying a higher amount than the standard $148.50. If you have recently retired or are working considerably less, it is possible that you are paying more for premiums than you should. The Social

Security administration looks back two tax returns when determining what your premiums amounts. If you have paid too much, you can request a refund when you file your tax return.

Example: Rene filed for Medicare Part B shortly after retirement. She was surprised by how high the monthly premium was going to be. This was due to the Social Security Administration looking back two tax returns when she and her spouse were high-income earners. Now that she is living off her Social Security benefits and life insurance proceeds, she will be reporting a much lower modified AGI this year when she files as a Qualifying Widow. Instead of over-paying each month, she filed Form SSA-44 to notify Social Security of her life-changing event. Shortly after, she was informed of the lowered monthly amount.

Q: What is a capital gains tax?

A: It is a tax paid on profits earned from selling assets such as stocks, bonds, mutual funds, real estate, and other types of investments. When these assets are sold at a profit, the government recognizes these gains as taxable. Simply put, the tax is calculated by taking the selling price of the assets and subtracting the original cost of the investment plus any tax already paid on reinvested earnings. If you've held the asset for less than a year, you'll pay taxes at your ordinary income bracket, but you currently pay at a lower rate if you've held the asset for more than one year. Inherited property is considered long-term property regardless of how long you've held it. Keep in mind that you may pay capital gains taxes annually on realized gains within a mutual fund, even if you do not sell the fund.

Below are charts on the current capital gains tax rates. The first is for long-term rates and the second is for short-term.

FILING STATUS	0% RATE	15% RATE	20% RATE
Single	Up to $40,400	$40,401 – $445,850	Over $445,850
Married filing jointly	Up to $80,800	$80,801 – $501,600	Over $501,600
Married filing separately	Up to $40,400	$40,401 – $250,800	Over $250,800
Head of household	Up to $54,100	$54,101 – $473,750	Over $473,750

Source: https://www.bankrate.com/investing/long-term-capital-gains-tax/

Federal short-term capital gains/income tax rate	Single	Married filing jointly	Married filing separately	Head of household
10%	Up to $9,950	Up to $19,900	Up to $9,950	Up to $14,200
12%	$9,951 to $40,525	$19,901 to $81,050	$9,951 to $40,525	$14,201 to $54,200
22%	$40,526 to $86,375	$81,051 to $172,750	$40,526 to $86,375	$54,201 to $86,350
24%	$86,376 to $164,925	$172,751 to $329,850	$86,376 to $164,925	$86,351 to $164,900
32%	$164,926 to $209,425	$329,851 to $418,850	$164,926 to $209,425	$164,901 to $209,400
35%	$209,426 to $523,600	$418,851 to $628,300	$209,426 to $314,150	$209,401 to $523,600
37%	Over $523,600	Over $628,300	Over $314,150	Over $523,600

Example: Helen's husband Joe was ill for quite some time prior to his death and accumulated $40,000 of medical bills seeking alternate treatments. The bills piled up during his illness but because all of their assets were highly appreciated, the couple's financial advisor recommended that they wait until after his passing to sell anything. Due to the step-up in basis that occurred at Joe's death, Helen was able to sell enough assets to pay the medical bills and save $14k in income taxes.

Q: What are the proposed tax changes on capital gains?

A: The Biden administration is proposing to increase these tax levels for those bringing in more than $1 million a year in household income at a new higher rate of 39.6 percent, regardless of how long the assets were held. This practically doubles the current rate of 20%.

Q: How could this affect investors and the markets?

A: Investors are concerned about how to prepare their portfolios, and some are selling appreciated positions now in an effort to lock in gains at today's potentially lower tax rates. Other Investors may begin to hold their assets to avoid taxes and forego any additional investment opportunities which could make the markets less efficient. Higher taxes on all appreciation, regardless of the time held, could discourage long-term investments in capital assets.

Source: https://www.wsj.com/articles/how-bidens-tax-plan-would-affect-investors-11619694009

Q: How do I determine whether it makes sense to take out taxable dollars or tax-advantaged dollars first?

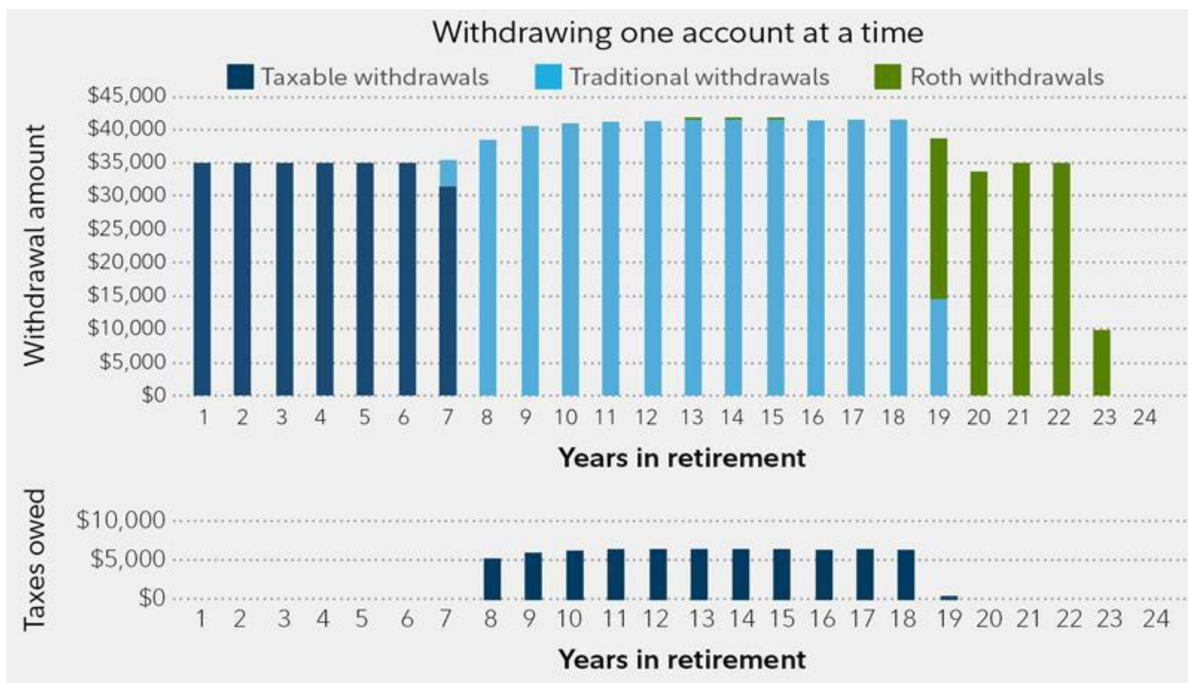
A: Taxation of withdrawals from accounts such as 401k's and IRA's varies greatly from the tax on Roth accounts or taxable accounts, so how and when you choose to withdraw from your different investment accounts can greatly impact your income taxes for that year. Most of us want to reduce our taxes as much as possible and the IRS expects taxes to be paid for the quarter that they were incurred to avoid penalties, so check with your tax advisor if you are unsure about the amount of your tax withholdings.

Example: Let's review several approaches of withdrawing to meet the needs of JoAnn who is 62 and widowed. She has $200,000 in taxable accounts, $250,000 in traditional 401(k) accounts and IRAs, and $50,000 in a Roth IRA. She receives $25,000 per year in Social Security and has a total after-tax income need of $60,000 per year. Let's assume she's earning a 5% annual return:

1. **Traditional approach: Withdrawals from one account at a time.**

If JoAnn takes a traditional approach, withdrawing from one account at a time, starting with taxable, then her 401k(k) and IRAs, and finally her Roth, her savings will last slightly more than 22 years and she will pay an estimated $69,000 in taxes throughout her retirement.

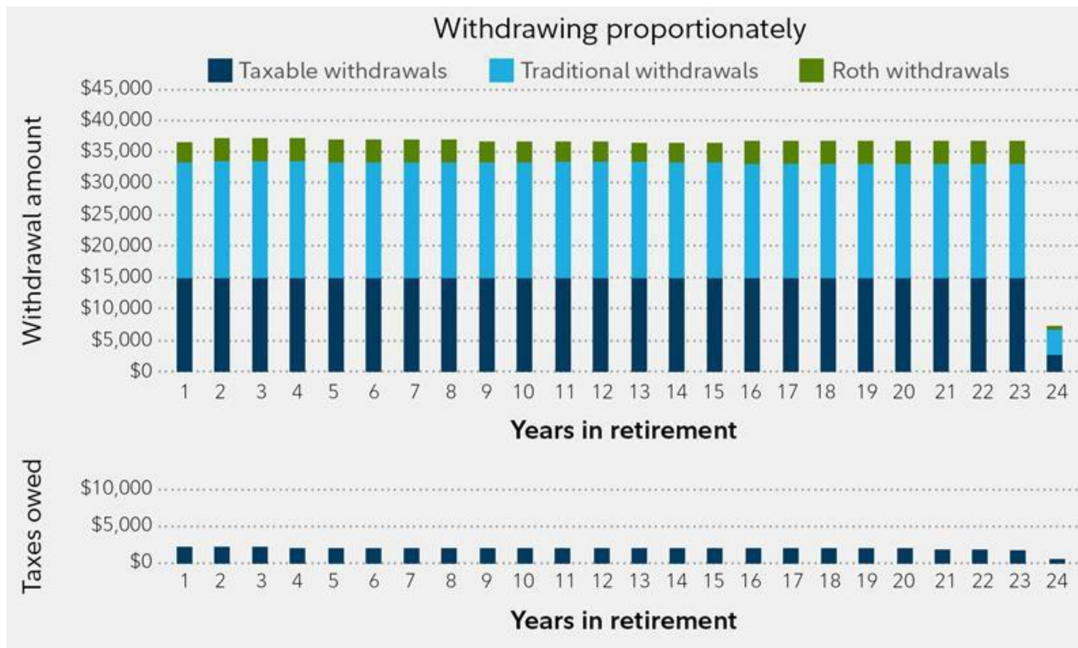
Note that with the traditional approach, JoAnn hits an abrupt "tax bump" in year 8 where she pays over $5,000 in taxes for 11 years while paying nothing for the first 7 years and nothing when she starts to withdraw from her Roth account.



For illustrative purposes only. Roth distributions are assumed to be eligible for tax-free and penalty free treatment.
*A 10% early distribution penalty may apply if you are underage 59½. In addition, the 401(k) and 403(b) may have plan limitations that would prevent a withdrawal prior to a triggering event such as death, termination, disability, or retirement

2. **Proportional Withdrawals**

This strategy spreads out and reduces the tax. As a result, it may extend the life of the portfolio.



Assumes 5% annual rate of return. Does not consider state and local taxes. All values in real terms and all tax rules assumed to be 2021 tax rules for entire time period.

Source: Fidelity Investments. For illustrative purposes only. Does not consider state and local taxes. All values are in real terms and all tax rules assumed to be 2021 tax rules for entire time period.
https://www.fidelity.com/viewpoints/retirement/tax-savvy-withdrawals

Q: How is Social Security taxed?

A: Social security is part of taxable income, and a portion is taxable if your modified adjusted gross income (AGI) is more than $25,000 as an individual. If you file single or head of household and your modified AGI is between the range of $25k to $34k, 50% of your benefits are taxable. If your modified AGI is more than $34k, 85% of your benefits are taxable.

Example:

Betty is a widow paying taxes as an individual. She earned $50k in dividends and income and gets $1.5k per month from Social Security. Because her AGI is greater than $34k, she will pay taxes on 85% of her $18k in annual social security benefits, so $15,300 of benefits will be included in her taxable income.

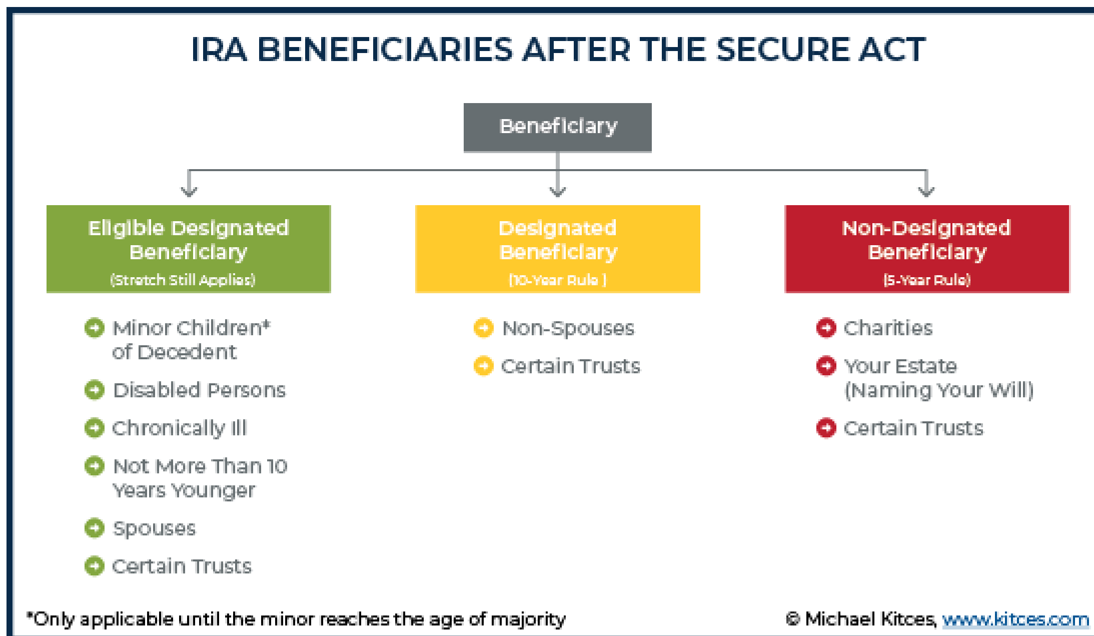
Q: Can you summarize how the Secure Act of 2020 affected required minimum distributions (RMDs)?

A: If you inherited a defined contribution plan or IRA after December 31, 2019, the Secure Act changed RMD periods for designated and non-designated beneficiaries. Surviving spouses (assuming less than a ten-year age difference) are excluded from this rule and still have the option to:

1. Complete a spousal rollover and treat is as her own RIA. The RMD would be calculated based on her age.
2. Set up an inherited IRA. RMD's will not start until her deceased spouse would have turned 72.

Designated beneficiaries (including those spouses who are younger than ten years or more) and non-designated beneficiaries no longer qualify for lifetime stretch periods and are limited to 10 and 5-year stretch periods, respectively.

See the chart below for the definition of designated and non-designated beneficiaries.



https://www.kitces.com/blog/secure-act-stretch-ira-401k-elimination-eligible-designated-beneficiary-retirement-accounts-taxes/

Example: Jeanine, age 60, was the sole beneficiary spouse of her husband's IRA. He died at age 69, before his Required Beginning Date of age 72). Jeanine currently does not need income from her IRA and can therefore roll it into a spousal IRA and defer the required minimum distributions until she turns 72.