Still Time to Contribute to an IRA for 2020 –

And Watch the Backdoor

February 2021

INTRODUCTION

Last month, the Pallas Capital Advisors Planning Team sent reminders to clients who had IRAs, that while the CARES Act suspended the requirement to take minimum distributions from IRAs in 2020, those required distributions must once again resume in 2021.

The increase in the required distribution amount was surprising to many who had suspended – after all, they were nearly two years older than they were when they took their last distribution, and many IRA balances had increased significantly in value over the past 18 months, even despite the COVID-19 pandemic, and the havoc it wreaked on the markets in the spring of 2020.

Since income tax filing season is once again in full swing, let us revisit the basics – deferring income tax with an IRA or Roth IRA.

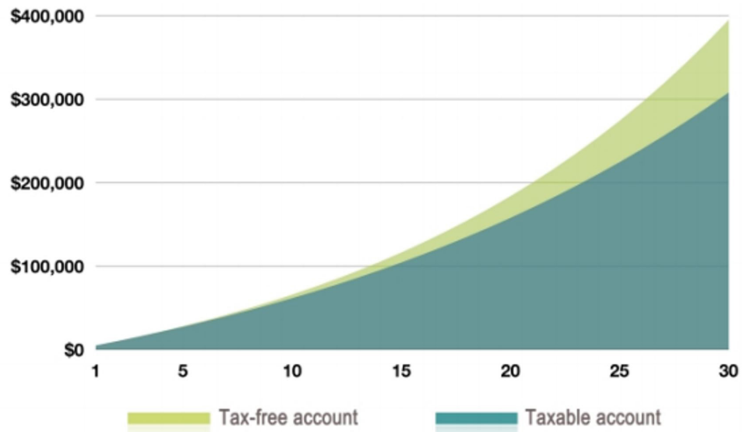
THE VALUE OF TAX DEFERRAL

Tax deferral is the process of delaying (but not necessarily eliminating) until a future year the payment of income taxes on income you earn in the current year. For example, the money you put into your traditional 401(k) retirement account isn't taxed until you withdraw it, which might be years down the road.

Tax deferral can be beneficial because:

- The money you would have spent on taxes remains invested.
- You may be in a lower tax bracket when you make withdrawals from your accounts (for example, when you are retired).
- You can accumulate more dollars in your accounts due to compounding.

Let's assume two people have $5,000 to invest every year for a period of 30 years. One person invests in a tax-free account like a Roth IRA that earns 6% per year, and the other person invests in a taxable account that also earns 6% each year. Assuming a tax rate of 24%, in 30 years the tax-free account will be worth $395,291, while the taxable account will be worth $308,155. That's a difference of $87,136.



YOU MAY STILL BE ABLE TO MAKE A 2020 CONTRIBUTION

Even though tax filing season is well underway, there is still time to make a regular IRA contribution for 2020. You have until your tax return due date (not including extensions) to contribute for 2020. For most taxpayers, the contribution deadline for 2020 is April 15, 2021.

CONTRIBUTIONS TO TRADITIONAL IRAs

Anyone who earned income or is married to someone with earned income can contribute to an IRA. Depending upon your income and whether you are covered by an employer-sponsored retirement plan, you may or may not be able to deduct your contributions to a traditional IRA, but your contributions always grow tax-deferred. However, you'll owe income taxes when you make a withdrawal.*

You can contribute up to $6,000 (for 2020 and 2021) to an IRA, and individuals age 50 and older can contribute an additional $1,000 (for 2020 and 2021).

**Withdrawals prior to age 59½ may be subject to a 10% federal income tax penalty unless an exception applies.*

Can you deduct your contributions to a traditional IRA?

As we said, you can **contribute** to a traditional IRA for 2020 if you had taxable compensation (i.e., earned income) in 2020. However, if you or your spouse was covered by an employer-sponsored retirement plan in 2020, *then your ability to deduct your contributions may be limited or eliminated,* depending on your filing status and modified adjusted gross income (MAGI). (See table below.) Even if you cannot make a deductible contribution to a traditional IRA, you can always make a nondeductible (after-tax) contribution, regardless of your income level. However, if you are eligible to contribute to a Roth IRA, in most cases you will be better off making nondeductible contributions to a Roth, rather than making them to a traditional IRA.

2020 income phaseout ranges for determining deductibility of traditional IRA contributions:

Covered by an employer-sponsored plan and filing as:	Your IRA deduction is reduced if your MAGI is:	Your IRA deduction is eliminated if your MAGI is:
Single/Head of household	$65,000 to $75,000	$75,000 or more
Married filing jointly	$104,000 to $124,000	$124,000 or more
Married filing separately	$0 to $10,000	$10,000 or more
Not covered by an employer-sponsored retirement plan, but filing joint return with a spouse who is covered by a plan	$196,000 to $206,000	$206,000 or more

2021 income phaseout ranges for determining deductibility of traditional IRA contributions:

Covered by an employer-sponsored plan and filing as:	Your IRA deduction is reduced if your MAGI is:	Your IRA deduction is eliminated if your MAGI is:
Single/Head of household	$66,000 to $75,000	$76,000 or more
Married filing jointly	$105,000 to $125,000	$125,000 or more
Married filing separately	$0 to $10,000	$10,000 or more
Not covered by an employer-sponsored retirement plan, but filing joint return with a spouse who is covered by a plan	$198,000 to $208,000	$208,000 or more

ROTH IRAs

Income-tax deferral is a timeless strategy for individuals who are trying to maximize their investment returns. Well, what is even better? Income tax avoidance (in the case of Roth IRA qualified distributions).

No Required Minimum Distributions – During the Owner's Lifetime

The required minimum distribution rules that apply to traditional IRAs and qualified retirement plans do not apply to lifetime distributions from Roth IRAs. However, as with traditional IRAs, beneficiaries must take minimum distributions after the death of the Roth IRA owner.

The SECURE Act of 2019 introduced the concept of an "eligible designated beneficiary" (EDB) to distinguish such beneficiaries from all other living designated beneficiaries. Eligible designated beneficiaries or IRAs, Roth IRAs, and retirement plans may continue to use the Single Life Table to calculate required minimum distributions. ***All other living designated beneficiaries*** (and this will include most beneficiaries) must receive the entire amount in the inherited IRA by the end of the tenth year following the year of inheritance.

Roth IRA Contributions

Roth IRA ***contributions*** are open only to individuals with incomes below certain limits - explained below. Your contributions are made with after-tax dollars but will grow tax-deferred, and ***qualified distributions*** will be tax-free when you withdraw them. The amount you can contribute is the same as for traditional IRAs. Total combined contributions to Roth and traditional IRAs cannot exceed $6,000 (for 2020 and 2021) for individuals under age 50.

Qualified Distributions from a Roth IRA

Qualified distributions include any withdrawal from your Roth IRA that meets both of the following requirements:

1. The withdrawal takes place after the end of the five-year period that started during the first tax year for which you made a Roth contribution.
2. The withdrawal either occurs after you turn 59 ½ or qualifies for exceptions to the general rule, including withdrawals made due to disability, for a first-home purchase, or to a beneficiary of the account after your death.

If you make a contribution - no matter how small - to a Roth IRA for 2020 by your tax return due date and it is your first Roth IRA contribution, your five-year holding period for identifying qualified distributions from all your Roth IRAs (other than inherited accounts) will start on January 1, 2020.

2020 income phaseout ranges for determining eligibility to contribute to a Roth IRA:

	Your ability to contribute to a Roth IRA is reduced if your MAGI is:	**Your ability to contribute to a Roth IRA is eliminated if your MAGI is:**
Single/Head of household	$124,000 to $139,000	$139,000 or more
Married filing jointly	$196,000 to $206,000	$206,000 or more
Married filing separately	$0 to $10,000	$10,000 or more

2021 income phaseout ranges for determining eligibility to contribute to a Roth IRA:

	Your ability to contribute to a Roth IRA is reduced if your MAGI is:	**Your ability to contribute to a Roth IRA is eliminated if your MAGI is:**
Single/Head of household	$125,000 to $140,000	$140,000 or more
Married filing jointly	$198,000 to $208,000	$208,000 or more
Married filing separately	$0 to $10,000	$10,000 or more

"BACK-DOOR" ROTH IRA CONTRIBUTIONS.... ARE CONVERSIONS

Even if you cannot make an annual contribution to a Roth IRA because of the income limits, there may still be a workaround. You can make a nondeductible (after-tax) contribution to a traditional IRA and then immediately convert that traditional IRA to a Roth IRA. This is sometimes called a "back-door" Roth IRA. This makes good sense for those individuals who do not have a lot of pre-tax IRAs already. For those that do – there are a few important considerations - read on.

Considerations around "Back-Door" Roth IRA Conversions:

There are important rules that an individual should consider when determining the impact of a Roth IRA conversion.

Traditional IRAs That Hold Previously Deducted Contributions:

The IRS aggregates your traditional IRAs as a single account when determining the amount of income tax you owe on distributions. From the IRS's standpoint, "distributions" include Roth IRA conversions. This fact may complicate backdoor Roth IRA conversions for people who already hold existing balances in traditional IRAs.

Those individuals could owe taxes on money they intend for a backdoor Roth IRA conversion—even if the money has already been taxed. This unfortunate event happens when the IRS's aggregation rule is combined with the pro-rata rule. The pro-rata rule states that once money enters an IRA, you cannot separate the portion that has already been taxed from the portion that was deducted from taxes.

For example, assume 60% of the funds in your combined IRAs were pre-tax contributions, and 40% were after-tax contributions. When you undertake a backdoor Roth IRA conversion, 60% of the money being converted to a Roth IRA would be taxed.

The Five-Year Rule Wrinkle for Converted Funds:

1. The five-year rule states that in most cases—even if you are over 59 ½—you generally cannot withdraw Roth IRA earnings free of taxes and penalties unless your first contribution to a Roth account was made at least five years ago. (You are allowed to withdraw contributions from your Roth IRA at any time, free of penalties or taxes.)

2. There is a second five-year rule, however, for backdoor Roth conversions. Because a backdoor Roth IRA is categorized as a conversion—not a contribution—you cannot access any of the funds held in the converted Roth IRA without penalty for the first five years after conversion. If you do a backdoor Roth IRA conversion every year, you must wait five years for each portion you convert. There are exceptions to this requirement, though, if you are 59 ½ or older or if you become disabled or die. Generally speaking, since the Roth IRA is designated for retirement, this rule may not have a significant impact on your decision.

IF YOU REALLY LOVED MAKING IRA CONVERSIONS

Finally, note that 2019 was the last tax year for which the age 70½ restriction on traditional IRA contributions applied. Due to passage of the SECURE Act in late 2019, beginning with the 2020 tax year, investors over the age of 70½ were able to contribute to a traditional IRA provided they had compensation equal to at least the amount of the contribution (spousal IRA rules will remain in effect).

SUMMARY

The important takeaway is don't overlook the opportunity to contribute – or convert your investment dollars into an account that could afford you the potential for tax-deferred growth, and in the case of the Roth IRA, tax-free distributions. This is particularly important if you believe that income tax brackets will creep upward in the years ahead. There's still time to plan ahead.

Sincerely,

James Landry, ChFC
Chief Operating Officer, Director of Planning
Pallas Capital Advisors