

## A New Risk To Converting To A Roth IRA

**C**onverting to a Roth IRA is appealing if you think Federal taxes will go up, but now carries a new risk. Roth conversion is still a good idea but it's important to understand how the rules changed and could come into play.

**Phantom Income.** The new risk to converting stems from a change in tax rules and it's

probably not going to make you decide against converting a traditional IRA to a Roth, but it is a material new factor in the equation, a risk to be taxed on "phantom income."

**Roth v. Traditional IRA.**

Roth conversions are likely to grow more popular because a Roth is taxed differently from a traditional IRA. You contribute pre-tax dollars to a traditional IRA, which lowers your taxable income each year you contribute. In retirement, you pay taxes on withdrawals to live on. In contrast, a Roth IRA allows you to contribute after-tax dollars and grows tax-free. Withdrawals in retirement are also tax-free. That's why converting to a Roth now looks smart if you think tax rates will be higher in your retirement years.

**Tax Rates.** The national debt and associated interest expenses are expected by the government to rise sharply due to years of Federal deficit spending, along with rising costs of

funding Social Security and Medicare benefits. As a result, tax rates could rise in the decade ahead, which would make withdrawing money from your traditional IRA cost you more in taxes annually in your retirement years.

**New v. Old Rules.** Until now you could convert to a Roth IRA and then push the "undo" button and reverse the



conversion in case of a sharp decline in your account value. The undo tactic has been around for years and it is important to understand what elimination of this technique means. Before 2018, you could reverse the Roth conversion that same year and suffer no ill effects, by using a tactic called a "re-characterization." The Tax Cuts and Jobs Act (TCJA) eliminated using this maneuver.

**Re-characterizing Example.**

Before tax reform, say you converted \$300,000 from a traditional IRA to a Roth in June. If you were in the 24% Federal tax bracket, you would have owed \$72,000 in April of the next year. In November, if the stock market

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## Key Tariffs, Rates And Economic Facts To Note In Fearful Times

**T**ariffs, interest rates, and recession struck fear deep in the heart of investors as 2019 was beginning. A market crash, a world financial crisis, or something worse. Here are some facts to help you keep perspective in these fearful times.

Assuming a trade war with China, JP Morgan earlier this year concluded it would result in a \$125 billion tariff on \$500 billion worth of imports on Chinese goods, but shave U.S. economic growth in 2019 by just one-tenth of 1%, according to an October 8, 2018 by Bob Davis, a senior editor at *The Wall Street Journal*.

Frightening headlines about Fed monetary policy have widely reported that, with the yield curve inverted, a recession is on the horizon. Actually, what the yield curve central bankers care about most — the one used to predict a recession — has not inverted. The financial press often mistakenly reports on the two-year versus 10-year Treasury bond when the yield curve that's most relevant in forecasting recessions is the 90-day Treasury.

No one can predict the next market turn and past performance is not a guarantee of the future of your investments. However, key economic fundamentals, like monthly orders by purchasing managers at large companies, were near a record high in November; real wage gains, which have repeatedly broken record high for three years, according to the Bureau of Labor Statistics, grew in the 12 months through October by 1.1%. These are not signs of a recession.

# The Big New Tax Break For Pre-Retired Professionals

**P**re-retired dentists, doctors and lawyers as well as other independent professionals may be able to save tens of thousands of dollars in income taxes annually during their peak income years under the new federal tax regulations. The new rules are complex. Here are 10 things pre-retired business owners need to know about qualifying for a 20% reduction in qualified business income under Section 199(A) of the new Internal Revenue Code:

1. Sole proprietors, LLCs, S corps, partnerships and other pass-through entities qualify.

2. Real estate and rental business income — including self-rentals — may qualify.

3. Some businesses are specified as ineligible and you may need a professional to determine if you qualify.

4. Service-business owners could get a deduction on 20% of their income, subject to income limitations.

5. A business owner with \$315,000 in taxable income owes tax on only \$252,000 — saving more than \$12,000 of income tax.

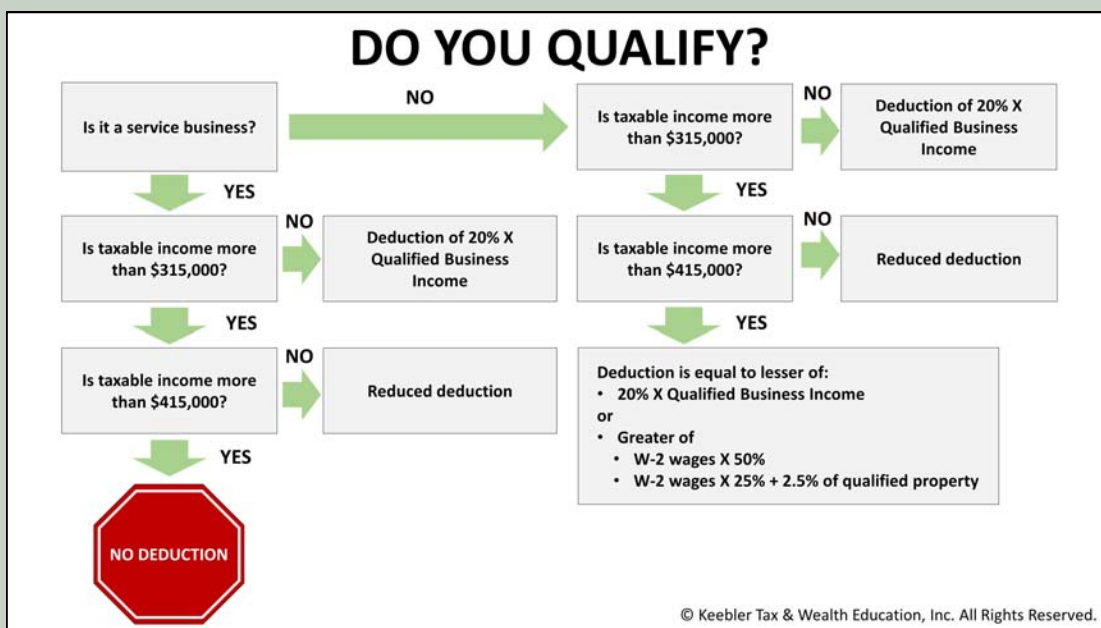
6. If you are married filing jointly and have more than \$315,000 of income, the 20% deduction is subject to a phase-out. The phase-out begins at \$157,500 for single filers.

7. If you have more than \$415,000 of income from the service business, the 20% deduction is eliminated (\$207,500 for single filers).

8. To keep your income below these thresholds, consider contributions to a defined benefit (DB) plan.

9. DB plans require you to commit to funding a defined benefit plan instead of a defined contribution plan, making them more complex.

10. A DB plan can supercharge retirement savings while minimizing your taxable income to enable you to qualify for the 20% deduction for business owners. ●



## Paying Off A Mortgage And The New Tax Code

**A**mong the most prized tax deductions to get trimmed by the Tax Cut And Jobs Act was the monthly mortgage interest. Should you pay off your mortgage, if your mortgage interest deduction is gone? The answer more often now is “Yes,” providing you can afford to retire the debt. If you can’t afford that now, aim to do it as soon as you can.

Due to a large increase in the standard deduction, fewer taxpayers qualify for the mortgage interest deduction. The standard deduction under the new tax law almost doubled to \$12,000 for single filers and \$24,000 for married couples. Only people with

deductions of more than those amounts can itemize and deduct their mortgage interest.

Piling up that much to itemize, especially for couples, will be difficult. As a result, the Tax Policy Center estimates that only 20 million Americans will itemize in 2018, as opposed to 46 million, had the tax law not changed.

Other changes in the law lessen the benefit of carrying the burden of a mortgage. There’s now a \$10,000 cap on deductions for state, local and property taxes. Before the law changed, the amount you could deduct was unlimited.

In addition, you are restricted from deducting interest on home equity loans if you use the debt for anything other than buying, building or upgrading a home. If you want to use the home equity loan for a tuition payment or to purchase a boat, Uncle Sam won’t allow it anymore.

If you have deductions totaling more than the \$12,000 and \$24,000 thresholds, you can still itemize. In many cases, you can save more money by erasing your mortgage than you could earn in “risk-free” investments.

Here’s the math. Say you have a \$300,000 mortgage, which is about the average amount nationally, at a 4%

# Strategic Considerations In Funding College

**F**ederal tax laws can help you fund a child or grandchild's college education in a variety of ways. Some key strategic considerations are outlined below:

**529 gets broadened, the pro and con.** Named after a section of the tax code, 529 college savings plans have been a revolutionary tool in the struggle to pay for higher education, which for decades has risen in cost much faster than the U.S. rate of inflation. 529s enable you to contribute an unlimited amount of after-tax dollars. 529s grow tax-free and withdrawals are also tax free, if used to pay for books, tuition, room and board. The Tax

Cuts and Jobs Act extended the 529's reach, so starting in 2018 you can use a 529 to pay for private pre-college education, K-12. Religious, military, gifted, and other specialized primary and high schools are, thus, more affordable. Keep in mind, paying for a child's education earlier could hurt savings for college. College and graduate schools generally cost much more than K-12 at a private school.

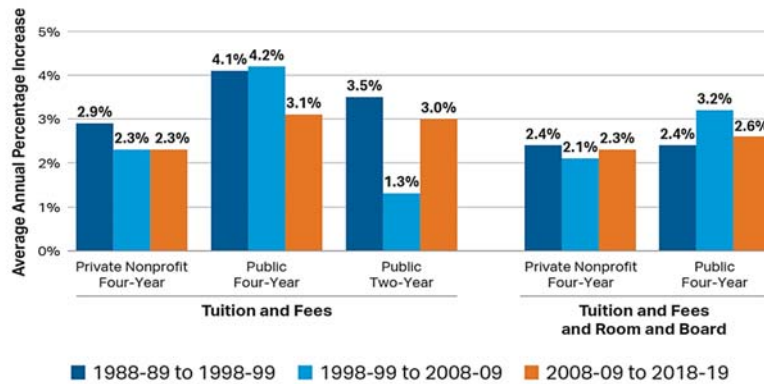
**Be clear on a 529's limits.** What if you don't use all the 529's proceeds? There are many ways to pay for college: financial aid and parents' pitching in, a student taking a side job to support paying tuition, etc. If a balance remains in the 529 account, you're generally paying for expenses other than education

career? If you opt for the first two years, you forfeit two years of growth at the outset. Statistically, odds favor the account growing more after taxes if you defer withdrawals.

**How to use a popular tax credit.** The American Opportunity Tax Credit provides a maximum annual credit of

\$2,500, and it is unavailable for singles with adjusted gross income of more than \$90,000 per year, or couples with more than \$180,000. Either the student or another taxpayer who declares the student as a dependent can take this credit. A caveat: You only can take the credit for four consecutive years and the academic

**Average Rates of Growth of Published College Costs by Decade**



Source: College Board, Annual Survey of Colleges; NCES, IPEDS Fall Enrollment data.

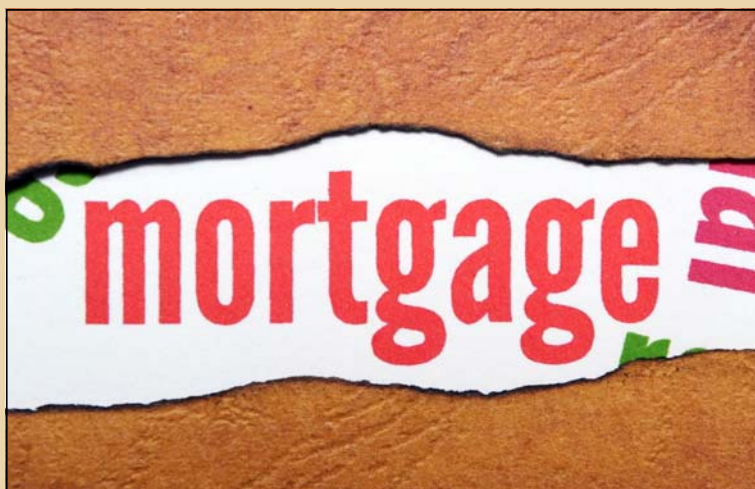
— like a down payment on a first home, is not permitted. If you use the proceeds for anything other than education, you pay a 10% penalty and income tax on the earnings segment of the withdrawal. A better idea: channel the money to a relative for schooling purposes.

**When to tap a 529.** And what if the 529 isn't enough to pay for an entire four years of college? Do you use the account at the beginning or end of a college

and calendar years don't line up, unless you start in January and graduate in December, four years later. That may mean, for students who follow the traditional college schedule, only three years are available: combining the last half of freshman year, sophomore and junior years, then the first half of senior year.

**The dependent question.** Parents can claim education credits for a student dependent, if the student receives over half of his or her support from mom and dad. The student can't earn more than \$4,000 annually.

**Bottom line.** According to College Board, a not for profit founded in 1900 to expand access to higher education, college—the cost of college rose 2.3% annually for private colleges and 2.6% for public colleges in the decade ended with the 2018-19 academic year. Private colleges are more expensive, costing an average \$34,740 for the 2017-18 school year, and public colleges came in at \$9,970. The bottom line is that it is wise for families — parents, grandparents and children — to articulate the choices and plan a comprehensive long-term strategic solution to this serious financial challenge. ●



If you pay off the mortgage, you no longer have to pay roughly \$12,000 annually in interest. When you did pay it, you received a tax deduction worth \$3,600 - 30% of the mortgage interest. So

yearly interest rate, and are in the 30% percent marginal tax bracket - 24% federal and 6% state levies combined.

that means, after the loan is retired, you saved \$8,400. That beats the risk-free Treasury bond return. ●



# Your Alma Mater Or Your Family?

**T**he new tax law doubles what you can leave loved ones' tax free when you die and that's really bad for your alma mater. Tax breaks for donations to your alma mater may no longer make the grade with you. Here's why:

## Estate Tax Exemption

**Rises.** The Tax Cuts And Jobs Act (TCJA) doubles a married couple's estate's tax-exemption to \$22 million. Alums now want to maximize their exemptions by leaving \$22 million to their children, nieces, nephews and other loved ones before even thinking about a donation to favorite old schools.

## Larger Standard

**Deduction.** The TCJA upped the standard deduction from \$13,000 to \$24,000 for married couples and most Americans no longer will itemize deductions. But that also means you no longer may deduct college donations. Younger alumni will never get into the habit of contributing to their alma mater, disrupting the finance of U.S. educational institutions.

## Athletic Deduction Nixed.

Before the TCJA, many colleges targeted contributions from alumni who might qualify for good seats at games. The old law allowed donors to deduct 80% of such gifts. Now, the deduction is zero.



**Taxing Endowments.** Under the new tax code, schools with endowments of \$500,000 per student or more and 500 students or more face a 1.4% levy on income. Only a small number of schools are subject to this new tax, but it is a consideration in making college donations.

**The Plus Side.** The TCJA is not

entirely bad for all education-minded donors. Some plusses:

- If you itemize, you may now deduct up to 60% of your adjusted gross income on donations to qualified charities, including your old school. That's up from 50%.
- You can "bunch" donations you pledge to give over several years. The deduction can exceed the write off under the standard deduction.
- You can contribute via a donor-advised fund, which entitles you to a large immediate deduction on annual donations you pledge to make over a period of years. If you suddenly strike it rich, this is a great way to go.

Old Ivy has been around since before the income tax and has managed to flourish, but the new economics of supporting education is disrupting the finances of major educational institutions and the effects are yet to be felt. If you have questions about donating money to a school or your priorities in planning your estate, please contact us. ●

## A New Risk To Converting

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plunged by 37%, as it did in 2008, your Roth IRA is now worth \$189,000. Making matters worse, you'd still have owed \$72,000 to Uncle Sam on the withdrawal of the full amount converted from your traditional IRA. You'd have to pay tax on income that was lost in the market decline. The tax reform eliminated the option of undoing the conversion to avoid paying tax on phantom income.

## The New Risk In Converting.

Since the new tax law eliminated this option, you now have little choice but to pay Uncle Sam the phantom income-tax and — should your account value plunge after converting — you must be prepared to stick with your

long-term strategy in the hope that the stock market will rebound. Past performance is no guarantee of your



future results, but a recovery is exactly what happened after the 2008 bear market. The climb back may take years

and it's possible — though unlikely — that it might never rebound. From its October 9, 2007 record high of 1565.15, the S&P 500 dropped to a low of 676.53 on March 9, 2009 in the near-collapse of the world financial system. It was not until March 28, 2013 that the S&P 500 surpassed its previous record closing high set in 2007 — a seven-year span.

**Bottom line.** The new risk of converting and getting hit by phantom income tax is now part of the equation in the math of retirement planning. However, if your Roth IRA has been compounded tax-free for the next decade and you can tap it for income without paying Uncle Sam a dime, then the math may indeed work better for you — especially if you believe tax rates are on the rise. ●