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The Specialist

ANSWERS TO TOUGH QUESTIONS ABOUT TAXES AND INVESTING

Benjamin C. Bruton

BRUTONCHISNELL ADVISORS

521 East Lancaster Avenue
Downingtown, PA 19335
Toll Free: (866) 518-3900
Fax: (610) 518-3880
Email: bbruton@bcadvisors.com
www.bcadvisors.com

Roth IRA Conversions: New Tax Law Gives and Takes Away

By Ed Slott, CPA

Roth IRA conversions often appeal to investors who want to create a tax-free income stream for their retirement years. However, when traditional IRA assets are converted to a Roth IRA, income tax is typically owed on the value of the converted assets in the tax year of the conversion.

The Tax Cuts and Jobs Act, passed in December 2017, lowers federal income tax rates, but it also ends a popular planning option known as recharacterization. These changes are likely to affect IRA owners' decisions about the timing and amounts of Roth conversions in 2018 and beyond.

You must consider whether it's in your financial best interest to convert and pay the taxes now or not convert and pay taxes on traditional IRA withdrawals later in retirement.

Roth IRA Advantages

If all conditions are met, the Roth IRA assets will incur no further income tax liability for the rest of the owner's lifetime or for the lifetimes of his or her designated beneficiaries, regardless of how much growth the account experiences. Qualified Roth IRA withdrawals are tax-free and penalty-free after age 59½ as long as the five-year holding requirement has been met.

Moreover, the original account owner is not subject to required mimimum distributions (RMDs), which otherwise must begin in the year he or she turns 70½. (Generally, IRA beneficiaries must take RMDs starting the year after the original owner's death.) Being forced to take RMDs before the money is needed often creates an unwelcome income tax liability. Plus, reporting a higher adjusted gross income (AGI) could subject more of Social Security income to tax and/or result in higher Medicare premiums.

Tackling Taxes

Converted assets are taxed as ordinary income, and if you are under age 59½, paying conversion taxes with money from your tax-deferred retirement assets could trigger a 10% early-withdrawal penalty. Thus, it's generally better to pay the taxes using money available outside of your retirement accounts.

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If you have any questions about the topics in this newsletter or about your financial future, call us. We are available to help.

Good News, Bad News for Boomer Retirement

The baby boom generation was the largest and longest birth bonanza in U.S. history, extending 18 years from 1946 to 1964.[1] With that wide spread, it's natural that older baby boomers might have different feelings and experiences regarding retirement than younger boomers.

A recent survey highlights this disparity and raises important questions for those who are still in the workforce.

Happy Retirees

The good news is that retired baby boomers are generally happy with their retirement experiences. Six out of 10 say they feel better than expected about retirement, and three out of 10 say it's about what they expected. Only 10% are disappointed or have negative feelings, typically citing financial stress.[2]

Three out of four said their financial situations at the time they retired were better or about the same as they expected. Only 23% did not meet their savings goals and had to adjust their spending. For many of them, reduced spending had not fundamentally changed their outlook on life, and closeness with friends and family often made up for lack of money.[3]

It's worth noting that even those with sufficient assets were surprised by how much they spent on health care, travel, and taxes.[4]

Worried Workers

By contrast, 59% of working Americans across all ages — and 65% of working boomers — said that worrying about having enough money in retirement was one of their top financial concerns. Only 27% of retired boomers said the same.[5]

Some of this difference might be due to fear of the unknown. While you are still working, the idea of living without a paycheck may seem daunting, even if you have a solid savings balance. Working boomers were more nervous about money than retirees even when both groups had similar nest eggs.[6]

However, there are some fundamental differences in financial experiences on the two ends of the boomer generation that are worth considering.

Declining pensions. In 1975, when many older boomers had entered the workforce, 88% of private-sector employees had a pension. By 2017, that had fallen to 33%. And many plans were frozen with reduced benefits after 2006.[7] Younger boomers are more likely to depend on income from a 401(k) plan, which places more responsibility on the worker for savings and potential retirement income.

Less favorable Social Security benefits. While full retirement age (FRA) is 66 for boomers born from 1946 to 1954, it increases by two months each year for those born from 1955 to 1959, and reaches 67 for those born in 1960 and later. This not only means younger boomers have to wait longer to collect full benefits, but it also reduces benefit percentages at other ages because they are based on FRA. Also, boomers born after January 1, 1954, cannot take advantage of a strategy in which one spouse files a restricted application for spousal benefits while continuing to earn delayed retirement credits to increase his or her worker benefit.

Rising college costs. People have children at different ages, but, in general, younger boomers have faced higher inflation-adjusted college costs that may have reduced the income available for retirement savings. They are also more likely to have provided their children with support after college.[8]

Higher long-term care costs. With longer life spans and rising long-term care costs, younger boomers also may face financial challenges helping their parents, or helping children and parents at the same time — a financial squeeze that gave rise to the term "sandwich generation."[9]

If you are at the younger end of the baby boom generation, this may sound discouraging, but every generation faces challenges. No matter how many years you have before retirement, it's wise to take a clear look at your strategy and make appropriate adjustments to put you on solid ground when it comes time to leave the workforce.

1) Pew Research Center, 2016
2, 4–6) benefitspro.com, December 8, 2017
3) *InvestmentNews,* December 6, 2017
7–9) *InvestmentNews*, December 2, 2017

Down the Donut Hole — The Medicare Coverage Gap

One of the most confusing Medicare provisions is the prescription drug coverage gap, often called the "donut hole." It may be clearer if you consider the gap within the annual "lifecycle" of Medicare Part D Prescription Drug Coverage. This also applies to drug coverage that is integrated into a Part C Medicare Advantage Plan.

Annual deductible. Prescription drug plans typically have an annual deductible not exceeding $405 in 2018. Before reaching the deductible, you will pay the full cost of your prescriptions, although you may receive negotiated discounts.

Initial coverage period. After you meet the annual deductible, your plan will pay a portion of your prescription drug costs, and you will typically have a copayment or coinsurance amount. A 25% coinsurance amount is the standard coverage required by Medicare, but most plans have different levels or "tiers" of copayments or coinsurance for different types of drugs.

Coverage gap. When you and your plan combined have spent a specified amount on drugs for the year — $3,750 in 2018 — you enter the coverage gap. In 2018, you pay 35% of your plan's price for covered brand-name prescription drugs and 44% of the price for generic drugs. The gap is closing over the next two years (see chart).

You remain in the coverage gap until you reach an annual out-of-pocket spending limit ($5,000 in 2018). Spending that counts toward the limit includes your deductible, copay, and coinsurance; the manufacturer's discount on brand-name drugs in the coverage gap; and your out-of-pocket payments in the gap. It does not include your premiums, the amount the plan pays, or your payments for noncovered drugs.

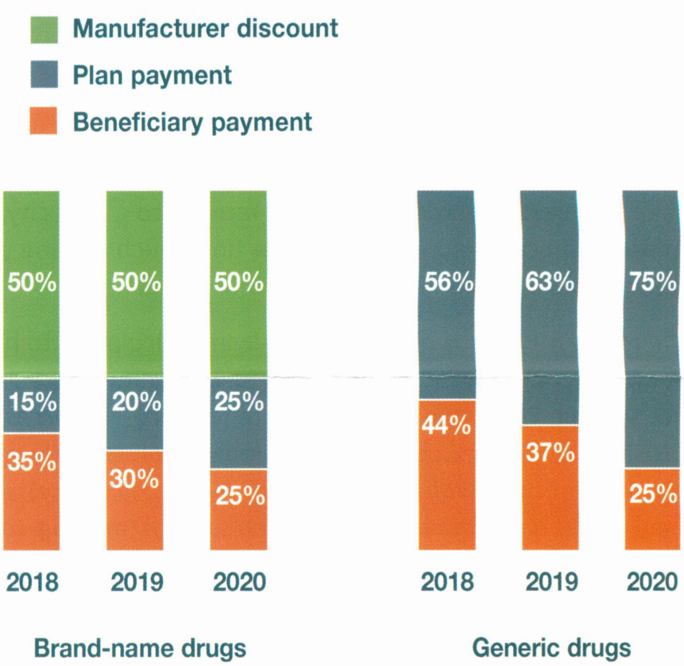
Catastrophic coverage. Once you have reached the out-of-pocket limit, you receive catastrophic coverage with much lower payments. In 2018, you would pay the greater of 5% of drug costs or $3.35/$8.35 for each generic and brand-name drug, respectively.

Some plans have more generous coverage in the gap. You may be able to avoid the coverage gap by using generic medicine, when appropriate, to lower your drug costs.

For more information, see ***Medicare.gov***.

Closing the Gap

Beginning in 2013, the Affordable Care Act required drug manufacturers to provide a 50% discount on brand-name drugs, and since then the percentage that beneficiaries must pay has been gradually reduced. By 2020, beneficiaries will pay no more than the standard 25% coinsurance amount for all covered drugs, effectively ending the coverage gap.



Source: Centers for Medicare and Medicaid Services, 2017

Where You Live Affects How Rich You Feel

Do you find it difficult to get ahead financially, even with a healthy household income? Does your friend or relative halfway across the country seem to have a better quality of life on less income? If so, the cost of living might be to blame.

Cost of living refers to the cost of a broad range of items necessary in everyday life. Housing is typically the largest factor — and often varies the most from place to place — but cost of living also includes transportation, food, utilities, health care, taxes, and miscellaneous expenses.

Your total tax bite will depend on state laws and policies. Seven states have no state income tax — Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming (Tennessee and New Hampshire tax only interest and dividend income) — and other states have different rules for taxing Social Security and pension income. Property taxes and sales taxes vary by state and even by county. The Tax Cuts and Jobs Act, which limits the annual deduction for state and local taxes, could make this difference even more significant for taxpayers in high-tax states.

If you have children, costs for child care, extracurricular activities, and tuition at your state's public universities could affect your bottom line. Some state universities are more affordable than others. If you are caring for an older person, or need care yourself, keep in mind that long-term care costs vary widely from state to state.

Salaries tend to be higher in more expensive metropolitan areas, but there's no question that your money will go further in some places than in others. If you're thinking of moving to a new city, cost-of-living information can help you determine how much income you would need to maintain the same standard of living.

There are numerous online cost-of-living calculators to help you compare your current location to a new location. Here are a few to get started: Economic Policy Institute (***epi.org/resources/budget/***), CNNMoney (***money.cnn.com/calculator/pf/cost-of-living/***), NerdWallet (***nerdwallet.com/cost-of-living-calculator***), and Bankrate (***bankrate.com/calculators/savings/moving-cost-of-living-calculator.aspx***).

Roth IRA Conversions

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Consequently, you must consider whether it's in your financial best interest to convert and pay the taxes now or not convert and pay taxes on traditional IRA withdrawals later in retirement. To help manage the tax liability, you may want to convert smaller amounts gradually over a number of years.

Now that income tax rates are lower, it may cost less to convert a portion of your retirement funds. However, market volatility could complicate your decision.

Assets that have fallen in value are generally good candidates for a conversion: You'll pay less in conversion taxes because of the depressed value, and you'll have the potential for future tax-free growth in the Roth IRA.

Before the new tax law took effect, you could "undo" or recharacterize a conversion. This option might have been welcomed if your financial situation changed unexpectedly during the year, or if the assets you converted declined in value after a conversion, because you probably wouldn't want to pay taxes on a value that no longer exists.

The prohibition on recharacterization applies to Roth IRA conversions made on or after January 1, 2018, so individuals who converted a traditional IRA to a Roth IRA in 2017 may still be able to recharacterize the conversion, as long as they do so by October 15, 2018.

Now that the new rules are in place, you may want to hold off on conversions until later in the year, when you have a more precise estimate of your income, tax burden, and investment performance.

Ed Slott is a professional speaker and the creator of several public television specials, including "Retire Safe & Secure! with Ed Slott." He is the author of *The Retirement Savings Time Bomb...And How to Defuse It* and many other books about IRA planning.