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The Backdoor Roth Is Back, for Now

By Ed Slott, CPA

The downside of building a well-padded nest egg using a traditional 401(k) or IRA is that when the account is tapped in retirement, withdrawals are taxed as ordinary income. But with a Roth IRA, contributions are not tax deductible, and qualified retirement withdrawals — including any earnings — are free of federal income tax, assuming the five-year holding requirement has been met. Such withdrawals also may be free of any state income tax. (Nonqualified earnings will be taxed and possibly subject to a 10% penalty if you are younger than 59½, unless another exception applies.)

Unfortunately, eligibility to contribute to a Roth IRA phases out above certain modified adjusted gross income (MAGI) levels: \$129,000 to \$144,000 for single filers and \$204,000 to \$214,000 for joint filers in 2022. If you would like to create a source of tax-free income in retirement, you can still convert assets in a traditional IRA to a Roth, or contribute to a Roth 401(k) offered by your employer, regardless of how much you earn.

One caveat is that Congress came close to banning Roth conversions for high-income taxpayers in late 2021, before the legislation stalled. So even though a Roth conversion could be a viable strategy for 2022, this opportunity may not be available in future years if lawmakers decide to revisit the issue.

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Roth Conversions

If your income exceeds the limits for annual contributions to a Roth IRA, you can make nondeductible (after-tax) contributions to a traditional IRA and then immediately convert the account to a Roth. This strategy is often called the back-door Roth IRA.

Converted assets — except for any after-tax contributions you've made — are subject to federal income tax in the year of conversion and may also be subject to state taxes (state laws vary). But if you convert after-tax contributions right away, they generate little or no earnings or current-year taxes. And under current law, your Roth account will incur no future tax liability, no matter how much the balance grows.

There is no limit to the number of conversions you can make or the amount you can convert. Thus, you might also consider whether it would be worthwhile to convert all or part of a traditional IRA that you already own while you still have the chance, but only if you can afford the tax bill.

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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.

PRACTICAL INSIGHTS FOR YOUR FINANCIAL GOALS

What's Your Retirement Dream Elevator Pitch?

Imagine stepping into an elevator and realizing that you're about to spend the 30-second ride with someone who could make your retirement dreams come true — if only you could explain them before the doors open again. How would you summarize your financial situation, outlook, aspirations, and plans if you had 30 seconds to make an “elevator pitch” about achieving one of your most important goals?

Answering that question — and formulating your own unique retirement dream elevator pitch — could help bring your vision of the future into sharper focus.

What Are Your Goals?

Start with an overview of what you hope to accomplish. That typically includes describing what you want, when you want it, and why. For example, you might say, “My goal involves retiring in 10 years and moving to a different state so I can be closer to family.” Or, “In the next 15 years, I need to accumulate enough money to retire from my regular job and open a part-time business that will help sustain my current lifestyle.”

If your plans include sharing life with a loved one, make sure you're both on the same page. Rather than assume you have similar ideas about retirement, discuss what you want a future together to look like.

Responses among workers in 2021 survey

72%



Were very or somewhat confident about being able to afford a comfortable retirement

31%



Made changes to their workplace retirement account strategies in the past year

32%



Said the pandemic negatively affected their ability to save for retirement

54%



Said they had either a major (18%) or minor (36%) debt problem

How Much Will It Cost?

To put a price tag on your retirement dream, consider working with a financial professional to calculate how much money you'll need. Making multiple calculations using different variables — such as changing your anticipated retirement date and potential investment growth rate — will help you develop a better understanding of the challenges and opportunities you may encounter.

It's important to remember that plans don't always work out the way we intend. For example, 72% of workers surveyed in 2021 said they expect to continue working for pay during retirement, but only 30% of retirees said they actually did so. And nearly half (46%) of current retirees left the workforce earlier than expected.¹ Understanding the financial implications of an unanticipated change in plans *before it happens* could make it easier to adjust accordingly.

How Will You Do It?

If your calculations indicate that you may be facing a retirement savings shortfall, take a fresh look at your spending habits to help find ways to save more money. Make a list of your fixed expenses and then keep track of your discretionary purchases every day for a month. It might be startling to realize how much you routinely spend on non-essential items, but you'll quickly discover exactly where to start applying more financial discipline.

Finally, you'll need to manage the funds you earmark for retirement by choosing the types of accounts to use and allocating your money within each account. If you have access to an employer-sponsored retirement account with matching contributions from your employer, you might want to start there and then invest in additional tax-deferred and taxable investments.

Regardless of the types of accounts you choose, your specific investment decisions should reflect your personal tolerance for risk and time frame, while addressing the priorities outlined in your retirement dream elevator pitch. If your retirement outlook changes at any point, take a fresh look at your investment strategy to make sure you're still potentially on course.

All investing involves risk, including the possible loss of principal. There is no guarantee that any investment strategy will be successful. Asset allocation is a method used to help manage investment risk; it does not guarantee a profit or protect against investment loss. There is no assurance that working with a financial professional will improve investment results.

Uncle Sam Wants to Know About Your Gig Income

If you earn money through an app or online digital platform, you may be affected by a tax reporting change that took effect on January 1, 2022. A provision of the 2021 American Rescue Plan requires third-party payment processors to report business transactions totaling over \$600 per year by issuing a Form 1099-K to the taxpayer and the IRS. In prior years, the reporting threshold was much higher (200 business transactions and \$20,000).

Here are a few things you should probably know about this far-reaching new rule.

It's not personal. Business transactions are defined as payments for goods or services, including tips. Money received from the online sale of personal items like old clothing or furniture, which are normally sold at a loss, is not taxable and does not need to be reported. However, those in the business of reselling goods for a profit should carefully track the original costs of their purchases. Peer-to-peer payment apps are not required to report personal transactions intended as gifts or used to pay back friends for dinner or trips, or to split other costs. How will third-party apps know the difference? The payer will likely be asked to indicate the purpose of each transaction so it can be categorized correctly.

It's not a tax change. Taxpayers who sell goods, regularly rent out a vacation home, walk dogs, or perform any other type of freelance work through digital platforms were already responsible for

self-reporting all income for tax purposes. But now the IRS will have a way to cross-reference the information sent by third parties with amounts reported by individuals and businesses on their tax returns.

It's not foolproof. In fact, this rule change is widely expected to cause confusion that could result in costly mistakes. If a payer (a roommate making a shared rent payment, for example) accidentally clicks on the wrong box, the recipient could receive a Form 1099-K for a transaction that is not taxable. It's also possible that a freelancer will receive a Form 1099-K from the payment processor and a Form 1099-MISC from the client for the same transaction. In such cases, the taxpayer may need to explain the discrepancy to the IRS.

Using separate accounts for personal and business-related digital transactions could make things much simpler at tax time. As always, keeping detailed and organized records will help ensure that your tax return is accurate, so you don't overpay or raise any red flags with the IRS.

Because the new reporting requirement may have unintended consequences that frustrate taxpayers, some lawmakers have proposed raising the threshold to a less onerous level. While it's far from certain that Congress will backtrack on this issue, you may want to watch for future developments. If you have questions about how the new rule might affect you, don't hesitate to consult a qualified tax professional.





Avoiding Probate

Probate is the process of proving the validity of a will and supervising the administration of an estate, usually in the probate court. State law governs the proceedings in the probate court, so the process can vary from state to state. Supervising the administration of an estate can result in additional expense, unwanted publicity, and delays in the distribution of estate assets for a year or longer, which is why planning to avoid the probate process may be beneficial.

There are several ways assets transfer on death directly from the decedent/owner to others without probate. The following are some of the more common ways.

Create a living trust. A revocable living trust is a separate legal entity that can be set up to hold assets. You can transfer most assets to a living trust while you're alive and have complete access to and control of those assets during your lifetime. You can also direct who is to receive assets held in trust upon your death. The use of trusts involves a complex web of tax rules and regulations, and usually involves upfront costs and ongoing administrative fees. You should consider the counsel of an experienced estate planning professional before implementing a trust strategy.

Name a beneficiary. Many types of contracts allow you, as the account owner, to designate a beneficiary or beneficiaries to receive the assets directly upon your death, avoiding probate. Examples include life insurance, annuities, and retirement accounts such as IRAs and 401(k)s.

Make accounts payable on death. Certain other types of accounts, such as bank accounts and brokerage accounts, also allow you to designate a beneficiary to inherit the account at your death without going through probate.

Own real estate jointly or create a life estate. Owning property jointly, as joint tenants with rights of survivorship, is another way to transfer property at death while avoiding probate. When one joint owner dies, property ownership automatically transfers to the surviving joint owner. You can also create a life estate in the property. In this case, you transfer ownership of the property to others, often called remainder beneficiaries, while you retain a life estate in the property. This means you have the right to use and control the property during your lifetime. Upon your death, complete ownership of the property passes to the remainder beneficiaries.



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.

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You can contribute up to \$6,000 to an IRA (traditional, Roth, or a combination of both) in 2022, or \$7,000 if you'll be age 50 or older by December 31.

401(k) Decisions

If your employer's retirement plan offers a Roth option, you could elect to make regular contributions on an after-tax basis to a Roth 401(k), pre-tax contributions to a traditional 401(k), or split your contributions between both types of accounts. In 2022, the maximum amount you can contribute to your 401(k) — Roth and traditional combined — is \$20,500, or \$27,000 if you are 50 or older. Just like a Roth IRA, qualified withdrawals from a Roth 401(k) are tax-free, provided all conditions have been met. Any matching contributions made by the employer must go into a separate pre-tax account and will be taxed as ordinary income upon withdrawal.

When you change jobs or retire, you may be able to leave the assets in your former employer's plan or transfer them to a new employer's plan, if allowed. You could simply withdraw the funds, which may not be the wisest choice due to the potential tax liability. You'll also have the option to transfer your Roth 401(k) balance directly to a Roth IRA, and your pre-tax funds to a traditional IRA.

It may also be possible to roll pre-tax funds to a Roth IRA, which would be a taxable conversion. If your employer's plan allows in-plan conversions, you might consider converting some traditional 401(k) assets to a Roth account while you are still working. Before implementing any Roth conversion, make sure you are prepared to pay the resulting taxes.