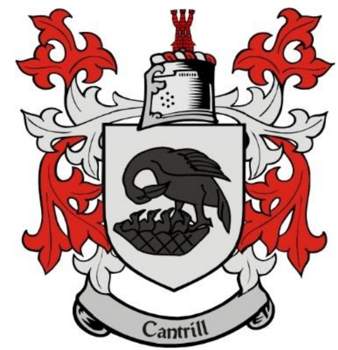

Cantrill Financial Group, LLC

NOVEL WAYS TO USE YOUR ROTH IRA

By Robert Powell
Published: April 17, 2015 4:10 p.m. ET

Earlier this month Jeff Levine, an IRA technical consultant with Ed Slott and Co. and MarketWatch RetireMentor, penned a column about using Roth IRAs to pay for college. And that got us thinking: What are the novel and unique ways to use a Roth IRAs and Roth 401(k)s? Here's what experts have to say:

Craig Adamson, president of Adamson Financial Planning:

Most parents cannot set aside enough money to fully fund retirement and college simultaneously. Even the best horticulture grads have yet to successfully grow a money tree in their backyards so what are those without green thumbs to do? A Roth IRA is a great dual-threat retirement-and-college-savings combo. Due to the ridiculous income limitations Congress has in place related to Roth IRAs, most clients who are middle class are perfect candidates for this strategy.

The asset is in the parent's name and it is in a retirement account, so doesn't get reported on the FAFSA. Due to the fact that most middle class families receive little or nothing for financial aid, we coach clients to have their child take out the maximum amount of student loans for which they are eligible – especially loans that may be subsidized or charging interest rates below 4%. Usually the loan eligibility doesn't cover the entire tuition or room and board bill – so we are not encouraging irresponsible borrowing.

Then after graduation (not while they are enrolled in school), we can use the parent's Roth IRA principal to assist with loan payments or take lump-sum distributions of principal to pay off the loans. Tax-free. Penalty-free. This gives us an extra four or five years of growth on the entire Roth IRA that helps offset robbing Peter to pay Paul. In other words, the gamble is investing in your own kids' future so they don't move home again. A side benefit might be their financially successful career will allow them to return the favor should you run short of cash because you took money out of your account to help them through school.

The other benefit to this strategy is that if their kids don't go on to college, the money continues to grow ta-free toward your retirement. You didn't set up a special account dedicated to pay for college that now has a bunch of strings attached to it when you want to pull money out to use in retirement.

J.R. Robinson, Financial Planning Hawaii, Inc. and Nest Egg Guru, LLC:

Small-business owners and family-run businesses, in particular, have many potential interesting opportunities to take advantage of Roth IRA/401(k) accounts. For instance, self-employed business owners can legally justify adding young children to the payroll, may wish to pay their kids enough earned income to make Roth IRA contributions. As any financial planner knows, a key to financial security in retirement is to save as much as you can, as early as you can. This

simple strategy of initiating retirement savings for teenage children may provide an enormous head start toward meeting the objective, and may also provide income tax savings to the parents by shifting income to the kids.

For one person businesses, establishing a 401(k) plan may offer significant savings opportunities as well. For 2015, a 401(k) plan participant may contribute up to $18,000 to his/her Roth 301(k) through salary deferral ($24,000 if age 50+). Additionally, if the plan document contains proper provisions, recent IRS rule changes may permit the business owner to contribute up to $35,000 of additional after-tax earnings to the plan up to the $53,000 annual defined contribution plan limit, which he/she may then convert to his/her Roth 401(k) account via an "in-plan conversion." Another variation of this strategy for solo-business owners may be to add one's spouse to the payroll and have one spouse make pretax 401(k) salary deferrals while the other makes after-tax Roth 401(k) deferrals in conjunction with the aforementioned after-tax contribution/in-plan conversion strategy. While there are many potential variations of this strategy for business owners, it should be noted that rules and restrictions surrounding such in-plan conversions are complex. As such, readers should carefully vet such strategies with their plan administrators and CPAs before implementing.

For regular working folks who participate in employer-sponsored plans and who have the means to contribute more than the 2015 salary deferral limits, if the employer plan document permits, the participant may be able to make additional after-tax contributions through payroll as well. While such contributions would merely grow on a tax-deferred basis, upon retirement or separation from service, thanks to a recent IRS rule change (IRS Notice 2014-54), these after-tax contributions may be rolled into one's Roth IRA, as long as the rollover is executed simultaneously with the rollover of the 401(k) holder's other pretax moneys to a traditional IRA. For more detailed information about this strategy, readers may wish to read Michael Kitces' September 2014 Nerd's Eye View piece, IRS Notice 2014-54 Acquiesces On Splitting After Tax 401(k) contributions for Roth Conversion.

For retirees, an annual partial conversion strategy can be a great way to shift pretax IRA money to tax-free Roth IRAs with minimal tax consequences. To the extent that the retiree may be in a low marginal tax bracket and has a significant pretax savings in a rollover IRA, it may make sense to convert just enough of the traditional IRA to his/her Roth IRA each year to remain in the 15% marginal bracket. In addition to the benefits of shifting tax-deferred savings to tax-free accumulation, if implemented over a number of years before the retiree turns 70 ½, this partial conversion strategy may significantly reduce the retiree's required minimum distribution from his/her traditional IRA.

Conversely, it is also worth mentioning that, in my opinion, the Roth conversion concept has been a bit overhyped, and that it may not be sensible for people to process Roth conversions if they are in high marginal tax brackets. Similarly, while much has been written about "backdoor" Roth conversions as a strategy for circumventing the income limitations on Roth IRA contributions, people considering such strategies should be aware of the pro-rata tax rule. In short, there are many wonderful opportunities for investors to direct savings into Roth accounts. However, given the complexity of the tax rules, investors considering such opportunities would do well to first see professional tax guidance.

Thomas O'Connell, president, International Financial Advisory Group:

There have been two unique uses for Roth IRA with my clients as of late.

First, we are finding more grandparents and some parents are using their Roth IRAs to fund for college expenses. As popular as the 529s are, they are an exposed asset on the FAFSA applications (even if owned by a grandparent) and could disqualify or reduce the amount of financial aid a student may receive. A Roth IRA on the other hand is an exempt

asset from the FAFSA application so when properly distributed and applied toward the tuition bill, it doesn't have a negative effect of financial aid.

The second thing – and hold on to your hat – is funding a life insurance policy. I know there will be negative commentary, but hear me out. The government is starved for money. So starved that they even proposed to do away with stretch IRA benefits and force required minimum distributions from Roth IRAs and Roth 401(k)s. Why? So they can recycle all that tax-free money back into circulation so it can be taxed again. It is only a matter of time until it becomes an actuality. So now the only tax fee option left is life insurance. Besides that, another great attribute of life insurance is the leverage. Where else can you take $1 and turn it into $2 or $5 or $10 of tax-free money for you doing your lifetime and for your family to protect them from what we know is coming? If that were all everyone should do it, but it's not. Engineered properly, you can receive living benefits such as long-term care, it can avoid probate, it can be creditor proof, it can give you safety of principal, uninterrupted compounding interest, guaranteed interest that is 300% to 400% more than a CD or savings account, plus life insurance is another of the exempt assets from FAFSA. And much more.

Tim Steffen, director of financial planning, Robert W. Baird & Co.:

We've been talking to more retired clients about the benefits on Roth conversions. Most people think of conversion as something to consider when you're younger and have lots of years to let the account grow tax-free, and those can in fact be great scenarios. However, don't dismiss the benefits of a conversion for retirees. Retirees tend to have lower levels of income, maybe even no taxable income after claiming deductions, so for those taxpayers a Roth conversion can be very tax-inexpensive, Rather than letting those low-income, low-tax years slide-by, take advantage of that time and convert a Traditional IRA to a Roth IRA at little to no additional tax cost.

Figuring out the optimal amount to convert while managing the tax liability can be tricky, however, and should involve a tax professional. The income generated by a Roth conversion can cause Social Security benefits to go from tax-free to taxable, and can also lead to reduced deduction for medical expenses or other items. It could even lead to higher Medicare premiums in the future, so it's important to do a dull tax calculation before executing a conversion. A simple with-and-without analysis can show just how large a Roth conversion to do before the tax cost makes it a less-effective strategy.

Even if the conversion triggers a small amount of tax for the IRA owner, it may still be the right long term planning strategy. If the retiree's financial plan shows they'll have more IRA money than they'll need during retirement, doing the conversion can reduce future Required Minimum Distributions that might otherwise be taxable at higher rates. In other words, it comes down to paying a smaller amount of tax now (and then earning tax-free growth for the rest of your life) or a larger amount of tax in the future.

An when comparing the tax now to what might be owed in the future, IRA owners shouldn't just look at their own tax rate, but also that for the account beneficiary – usually the owners children. Those children are likely to be in a higher tax bracket than mom and dad when they inherit the account, so the parents can pay little or no tax upon a conversion, allowing their kids to avoid higher tax cost when they eventually inherit the account. It's a form of gift to the beneficiaries, without the usual gift tax implications.

David Richmond, founding partner and president, Richmond Brothers:

The three ways we think most people use Roths or Roth 401(k)s unconventionally are as follows:

- For those that want control, many contribute to Roth IRAs to fund college funding. For example, if you contribute for 18 years at $5,500 a year that $99,000. You can always get your basis out of the Roth IRA at any time. If you are under 59.5 you will have limits on getting the gain out but it can be done, just maybe not tax or penalty free. This allows people to keep the money in their own name so if kids get scholarships and the like they don't have to have money tied up in 529 plans or educational IRA's. IT is poised to help their own retirement.
- Grandparents funding Roth IRA contributions once kids begin to go to work. We have several clients who set up a incentives with grandchildren that if they work they will help them fund a Roth in equal (or 25 cents on the dollar or 50 cents or whatever someone wants to do) to help teach the kids to save for the long term: $5,500 contributed (summer earnings) from age 16 to 62 has you contributing $253,000, but growing over 40 years that money is worth $2.485 million. Not a bad start from Grandpa and Grandma.
- We have a client who contributes to an IRA for the tax deduction. He invests a portion of the portfolio in speculative holdings knowing they are going to be very volatile. When the stock drops in value (say 25-50%) he converts them to a Roth IRA. It cost him taxes but less than his deduction since it is at a lower figure when he converts. When the asset recovers or grows, he has a lot of tax free gains. We have several clients that use this approach that now have six-figure Roth IRAs that cost them significantly less money.

Phillis Sax Pilvinis, president and founder, PSP & Associates:

Oftentimes we advise grandparents to contribute to Roth IRAs and or Roth 401ks or do conversions to Roth's for the purpose of helping out their grandchildren with education costs instead of contributing to a 529 plan. These options are often a lot better because unlike the 529s with limited investment options, Roths generally have more investment options. Also with 529's there are stringent guidelines of how the funds can be used while the Roths have a lot more flexibility.

Gary Cotter, managing director, Cotter Financial:

We have had situations where clients have large positions of appreciated securities that have a relatively low yield (employer stock, usually) outside their IRA. IF the clients are charitably inclines, we have use a charitable remainder trust or a charitable gift annuity to enable them to sell the appreciated stock without capital gains tax. They also get a substantial tax deduction for the charitable contribution. This can be used to offset the tax on a Roth conversion. In addition, the income from the trust or annuity, if not required for client's lifestyle, can be used to purchase life insurance to replace the value of the donated stock for the heirs.

Recently, one variable annuity company introduced an interesting death benefit option that worked for one of our clients. This client didn't plan to use her Roth IRA assets, but wanted to maximize the tax-free inheritance for her kids. While we ordinarily might not recommend a variable annuity as a Roth IRA investment, this death benefit made it an attractive option for this client. Upon her death, kids receive the greater of account value or adjusted purchase payments plus an additional 30% of the account value. The caveat is the client must live for five years after purchase to

obtain the additional benefit, otherwise the fee for this rider will simply be refunded. Taking into account the annuity fees, this still provides an attractive opportunity for the client who wants some downside protection for heirs.

Barry Goldwater, principal, Goldwater Financial Group:

That is a question that is a little more complicated than it may indicate. In 2010, when the Treasury gave us that 2-year window to convert unlimited IRA assets to Roths, wealthy people who could absorb that tax converted. By the same token, these are people who do not need this income at this point in time and plan on giving their kids a tax-free gift.

But I have done this kind of planning twice with Roth IRA clients. Leveraging tax-free income into tax free personal and family benefits and these benefits are huge. I have two client who have million-dollar-plus IRA accounts and they also pay large life insurance and long-term care premiums. One of my clients pays $50,000 for both premiums and the other slightly more.

So for the sake of this story, we converted $1 million of the Roth money to an annuity with a 5% payout rate. We locked in $50,000 of income from the annuity, tax free for life and they payments of the annuity go directly into his checking account.

At the same time, the premiums for his life and long-term care come directly out of the checking through wire transfer going directly into the life and long-term care policies. My clients are not aware of these three transactions until the annual statements come by email.

The reason they are not aware and can be somewhat frivolous is because there is no tax on this $50,000 of income. It allows my clients deep peace of mind knowing they are 100% protected against dying too young, living too long with major health issues and paying taxes on $50,000 of income. We have leveraged their tax free income into a plethora of tax free benefits, both for themselves and for their family.

www.marketwatch.com/story/novel-ways-to-use-your-roth-ira-2015-04-17