Tax Update:

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Retirement Provisions of House Ways and Means Committee Tax Proposal

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High Earners with Very Large Retirement Plan Balances See a Big Impact

Taxpayers in the highest proposed tax bracket of 39.6%, including single filers with taxable income in excess of $400,000, married filing jointly with taxable income in excess of $450,000 and head of household filers with taxable income in excess of $425,000 have been the target of much of the proposed legislative changes. Retirement accounts also did not go untouched.

Contributions to traditional IRA and Roth IRA Changes:

The new rules would prohibit contributions to traditional IRAs and Roth IRAs for certain taxpayers with combined assets in their IRA accounts and defined contribution plan accounts in excess of $10 million. These limits would apply to single taxpayers and married taxpayers filing separately with taxable income greater than $400,000; or married filing jointly with taxable income greater than $450,000; or filing head of household with taxable income greater than $425,000. It is important to note that the individual must meet both the combined account balance of over $10 million and exceed the applicable taxable income threshold. Individuals who only meet one criteria will not be affected.

Also, there are no limitations on additional contributions to employer sponsored plans in the proposal.

The annual 401(k) contribution limits are $19,500 plus an extra $6,500 for those who are 50 or over. When profit sharing contributions are added in, the maximum combined employee and employer contribution limits are $58,000 and $64,500 for 2021.

By contrast, the 2021 annual contribution limits for IRA's are $6,000 with a $1,000 age 50+ catch-up contribution. The legislation is targeting traditional IRAs since there are already income limitations for Roth IRA contributions.

HOW TO CALCULATE MAGI?
Modified Adjusted Gross Income (MAGI) can be determined in a 3 step process:

1. **Figure out your gross income for the year (this appears on line 9 of IRS Form 1040)**
2. **Calculate your adjusted gross income (this appears on line 11 of IRS Form 1040)**
3. **Add back certain deduction to your AGI. Any deductions taken for IRA contributions and taxable Social Security payments, losses from a partnership, passive income or loss, rental losses and a few other rare ones.**

Currently anyone can contribute to a traditional IRA regardless of their income level. The question of whether the contribution is deductible (pre-tax contributions) or non-deductible (after-tax) depends on your modified adjusted gross income (MAGI) and whether you are a participant in an employer-sponsored retirement plan.

Traditional IRA Deductibility

Filing Status	Covered by Employer Retirement Plan?	Modified AGI 2021	2021 Deductibility
Single	No	Any Amount	Full Deduction
	Yes	$66,000 or less	Full Deduction
		$66,001 - $75,999	Partial Deduction
		$76,000 or more	No Deduction
Married Filing Jointly	Neither Spouse Covered	Any Amount	Full Deduction
	Both Spouses Covered	$105,000 or Less	Full Deduction
		$105,001 - $124,999	Partial Deduction
		$125,000 or more	No Deduction
	One Spouse Covered, Rules for Covered Spouse	$105,000 or Less	Full Deduction
		$105,001 - $124,999	Partial Deduction
		$125,000 or more	No Deduction
	One Spouse Covered, Rules for Non-Covered Spouse	$198,000 or less	Full Deduction
		$198,001 - $207,999	Partial Deduction
		$208,000 or more	No Deduction

To contribute to a Roth IRA, your MAGI must be below the limits specified by the IRS. If you're within the income "phaseout range," the actual amount you can contribute is also determined by your MAGI. If a single taxpayer's MAGI is below $125,000 they can make a full contribution to a Roth IRA. If the taxpayers are married filing jointly, they can make a full Roth IRA contribution if their MAGI is below $198,000. It is anticipated that these MAGI limits would stay untouched by the proposed legislation, albeit with a slight cost of living increase in 2022.

Roth Contribution Phaseout
MAGI Phaseout range for contributions made to Roth IRAs in 2021

Married Filing Jointly	$198,000 - $208,000
Married Filing Separately	$0 - $10,000
Single	$125,000 - $140,000.

Required Minimum Distribution (RMD) Provisions Affecting High-Income Taxpayers

The proposed legislation imposes RMDs for taxpayers whose combined balances in IRA accounts (both traditional and Roth) and defined contribution plans are between $10 million-$20 million at the end of a taxable year. These taxpayers must distribute 50% of the excess amount over those combined balances in the form of an RMD during the following year.

For example, a taxpayer has combined Traditional IRA and 401(k) plan balances of $10,500,000 on 12/31/2023. The IRA owner has $500,000 in excess IRA balance over the $10,000,000 limit therefore they must distribute 50% of the excess, or $250,000, in the form of an RMD no later than December 31 of 2024.

The proposed legislation doesn't stop there. If the combined balance at the end of the taxable year is greater than $20 million, then the taxpayer must distribute the 50% of the excess RMD mentioned above, but first must distribute the lesser of:

- 100% of the year-end balance above $20 million, or
- 100% of the balance in ALL Roth Accounts.
  The 10% pre-59 ½ early-distribution penalty tax would not apply to distributions required because of the $10 million or $20 million limits.

To summarize the above, if the aggregate retirement account balance exceeds $20 million, the excess will be required to be withdrawn as an RMD. If the aggregate balance is between $10 million and $20 million, 50% of that amount will need to be withdrawn as an RMD. Any Roth retirement funds need to be distributed first in order to satisfy these new RMDs. These new RMDs apply regardless of age, even if the owner has not yet attained age 72.

Roth Conversion limitations for High Income Taxpayers

In general, taxpayers can convert all or a portion of a traditional IRA or defined contribution plan account into a Roth IRA without taking into consideration the level of their taxable income.

The proposal provides for a 10-year window of opportunity to convert pretax accounts to Roth IRAs for high income taxpayers.

The proposed legislation would prohibit Roth conversions for taxpayers in the highest proposed income tax bracket of 39.6%, this includes single taxpayers and married taxpayers filing separately with taxable income over $400,000, $450,000 for married taxpayers filing jointly, and $425,000 for heads of household. The proposal includes a 10-year window of opportunity to convert pre-tax accounts to Roth IRAs. This proposal would not be effective until January 1 of 2032. The reason for the 10 year delay of the effective date may be because of the current revenue being generated from Roth conversions right now.

All Taxpayers - Roth conversions are not allowed for distributions that include after-tax contributions after December 31, 2021

The legislation is proposing that amounts held in a traditional IRA or defined contribution plan cannot be converted to a Roth IRA or designated Roth account if any portion of the distribution being converted consists of after-tax or nondeductible contributions. This would eliminate the use of the Backdoor Roth IRA and Mega Backdoor Roth IRA strategies, discussed in more detail below.

The Backdoor Roth IRA
Taxpayers who are unable to make contributions to a Roth IRA due to income limits can currently make non-deductible contributions to a traditional IRA and then soon thereafter convert the nondeductible contribution to a Roth IRA. These are known as “back-door” Roth contributions.

The Mega Back Door Roth
Similarly, a defined contribution plan participant, if the plan allows, can contribute after-tax dollars to their plan and do a low to no tax intra-plan conversion to the Roth account or an in-service withdrawal (if eligible) conversion to a Roth IRA. These are known as mega back door Roth strategies, that allow an individual to potentially add another $38,500 to a Roth account, which is much more than the $6,000 or $7,000 Roth IRA limit!

What’s interesting is that the strategy of converting after-tax IRA contributions to a Roth IRA isn’t always easy for taxpayers to do. Take for example the back-door Roth strategy of contributing after-tax or non-deductible contributions to traditional IRAs and then immediately converting the after-tax contribution to a Roth IRA at little to no tax cost. The caveat here is the aggregation rule. All traditional IRAs must be aggregated to determine the taxability of the Roth IRA conversion. A taxpayer cannot keep nondeductible after-tax contributions in one traditional IRA and have pre-tax contributions in a separate traditional IRA and think that they are going to just convert the after-tax dollars to a Roth IRA.

To prevent this isolation of after-tax dollars, all IRA account balances (including SEP and SIMPLE IRAs) must be aggregated to determine the ratio of after-tax contributions, pre-tax contributions and investment growth. This accounting must be preserved utilizing IRS Form 8606 for as long as there are after-tax dollars in the IRAs. The form must be filed every year you take a distribution from IRAs with after-tax contributions, execute a Roth conversion or take a distribution from a Roth IRA. The IRS has gone to great lengths to ensure that a taxpayer cannot access just the after-tax cost basis in IRAs.

Many experts were surprised when IRS Notice 2014-54, Guidance on Allocation of After-Tax Amounts to Rollovers was released. This notice is specific to how taxation applies when a retirement plan participant takes both pre-tax and after-tax funds from a qualified plan (401(k), 403(b) or 457(b)). This notice states that plan participants with both pre-tax and after-tax money in their employer plans can allocate the pre-tax portions of their plan distributions to a traditional IRA rollover and the after-tax portion of their rollover to a Roth IRA in a tax-free conversion. This guidance paved the way for the Mega Backdoor Roth.

So how does this strategy work? If the Roth 401(k) plan allows for after tax (non Roth) contributions a taxpayer can conceivably do a low (or no) tax conversion into Roth dollars. This includes both strategies of executing an intra plan Roth conversion to the Roth account if the plan allows it or rolling the funds out to a Roth IRA in a Mega Backdoor Roth strategy. If a plan participant is eligible for an in-service withdrawal or has separated from service, they will need to instruct the plan administrator to cut two rollover checks: one for all the pre-tax money to be directly rolled over to a traditional IRA and a second for after-tax monies to be converted to a Roth IRA. If the plan does not offer an in-service withdrawal option, the strategy could be executed once the participant is eligible to receive a distribution upon separation from service.

Unlike taking an in-service withdrawal where you can separate pre-tax and after-tax monies, part of the intra-plan conversion may include earnings on after-tax contributions that accumulated prior to executing the intra-plan conversion. The idea would be to do a conversion relatively soon after the contribution to limit the gains applicable to the after-tax contribution. To execute this intra-plan Roth conversion, the employer plan must offer a designated Roth account and must allow employee voluntary after-tax contributions.

Perhaps most importantly, the taxpayer also needs to have sufficient after-tax money to contribute more than the salary reduction contribution of $19,500 (+$6,500 if over age 50) to execute the mega back-door Roth strategy.

Understanding Contribution Limits and the Mega Back-Door Roth IRA

Plan Type	Plan Participant Age 50+
Salary Deferral Contribution made to Traditional 401(k)	$26,000
Employer Match (always pre-tax and varies according to plan)	$3,000
Employee – Voluntary Nondeductible Contributions	$35,500
Total Plan Contribution Limit	$64,500

Limitation on IRA Investments

Additional proposed legislation would prohibit an IRA from holding any security if the issuer of the security requires the IRA owner to have a certain minimum level of assets or income, or to have completed a minimum level of education or to have obtained a specific license or credential. This rule would apply in 2022 for new investments however the rule would include a 2-year transition period for IRAs already holding these investments. An example of this would be an accredited investor, a status usually reserved for wealthy investors, seeking to buy a private investment. Traditional IRAs with these investments would lose their tax deferred status.

Potential Actions to Consider Now:

✓ Take advantage of the back-door Roth and the Mega back-door Roth strategies as described above.

✓ If you are in the proposed top tax bracket, and your future plans included periodic Roth conversions, it may be time to accelerate or reformulate a strategy to take advantage of the 10-year window of opportunity to convert.

✓ Work with your Key Bank Advisor to illustrate what your future Required Minimum Distributions are projected to be. It's important to determine whether your guaranteed sources of income such as Social Security, annuity and pension payments, plus your projected RMDs are going to provide you more income than you need in retirement. Depending on your objectives, it may not make sense in your overall plan to pay taxes on income you do not need or want. Converting traditional IRA and 401(k) balances to a Roth IRA reduces the value of the traditional IRA and/or employer sponsored plan which results in lower required minimum distributions in the future.

✓ Work with your tax advisor to determine how much "room" you have in your current tax bracket to complete a Roth conversion without pushing you into the next marginal tax bracket.

✓ Qualified distributions from Roth accounts are tax free and penalty free, however they are funded with after-tax dollars. Having tax diversification in retirement -that is money allocated among tax-free, tax-deferred, and taxable accounts - provides you the most flexibility and control over your future tax liability. Talk to your advisors to determine if converting or contributing to a Roth makes sense in your long-term financial plan.

Reach out to your KeyBank Advisors to determine what action, if any, should be taken now to prepare for future tax legislation changes.

About the Author

Gretchen Miller focuses on planning and executing her clients' wealth management plans to meet their unique financial objectives and grow and preserve wealth. She coordinates the implementation of wealth management strategies while proactively delivering the latest insights and advice to benefit clients' particular situations. Before Key, she served as Director of Advanced Planning for Prudential Financial, where she was a subject matter expert on financial and estate planning and on a host of retirement topics.

Gretchen has more than 25 years of experience in financial services and earned an MBA from the University of Phoenix. She also obtained her certification as a Certified Financial Planner™.

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