

Tax Diversification Strategies and Tax Research

2021 MichALL Fall Education Meeting, 11/12/21



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Your Tax Journey

- Tax Law Authority
- Information Resources for Tax Research
- Employer Plans (401(k) and 403(b) plans)
- Individual Retirement Plans (IRAs)
- Tax Diversification Strategies
- Tax Preparation Assistance
- IRS Tools and Tax Tips

US Federal Tax Law Authority Hierarchy

- US Constitution
- Internal Revenue Code
- US Treasury Regulations
- Legislative History
- Judicial Authority
- IRS Positions and Publications
- Secondary Sources
- WWDD?

Information Sources for Tax Research

- What Tax Attorneys and Academic Researchers use:
 - IRS Code - Cornell
 - Tax Products - Checkpoint (RIA), VitalLaw (CCH), Bloomberg Tax (BNA)
 - Court Decisions - Lexis, West, Hein, Bloomberg Law, etc. (ex. Cohan v. Commissioner, 39 F.2d 540)
- What Tax Preparers use
 - IRS Pubs – IRS Website (ex. Pub 17)
 - Professional Associations
 - Secondary Sources
 - Kiplinger Tax Letter and Personal Finance
 - Quickfinder Handbook (Thomson Checkpoint)

Diversified Tax Portfolio

- Tax diversification vs Financial diversification
- Why diversify?
 - Minimizing risk through hedging
- Set up multiple “tax buckets”
- More buckets = more flexibility = more opportunity


Employer Plans (401(k) and 403(b))

- Applicable to all 401(k) and 403(b) plans
 - Established by the employer
 - Often have an employer matching contribution
 - Contribute up to \$19,500 (\$26,000 if age 50 or older)
 - Borrowing usually permitted against the balance
 - Must start withdrawing a minimal amount at age 72
 - 10% Penalty for withdrawals before age 59 ½*

**See exceptions to penalty later*

Employer Plans (401(k) and 403(b))

- Two types of “buckets” within the employer plan
 - 1. Pre-tax buckets
 - *Deduction on amount contributed now; tax is paid upon withdrawal*
 - *More \$ in paycheck*
 - 2. After-tax buckets (aka Roth 401(k) and 403(b))
 - *No deduction when contribution made; no tax due at retirement (tax-free growth)*
 - *Less \$ in paycheck*

a Employee's social security number		OMB No. 1545-0008		Safe, accurate, FAST! Use				Visit the IRS website at www.irs.gov/efile		
b Employer identification number (EIN)				1 Wages, tips, other compensation		2 Federal income tax withheld				
c Employer's name, address, and ZIP code				3 Social security wages		4 Social security tax withheld				
				5 Medicare wages and tips		6 Medicare tax withheld				
				7 Social security tips		8 Allocated tips				
d Control number				9		10 Dependent care benefits				
e Employee's first name and initial		Last name		Suff.		11 Nonqualified plans		12a See instructions for box 12		
f Employee's address and ZIP code						13 Statutory employee <input type="checkbox"/>		12b		
						Retirement plan <input checked="" type="checkbox"/>		Third-party sick pay <input type="checkbox"/>		
						14 Other		12c		
								12d		
15 State Employer's state ID number		16 State wages, tips, etc.		17 State income tax		18 Local wages, tips, etc.		19 Local income tax		20 Locality name

Form **W-2** Wage and Tax Statement

2021

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Individual Retirement Accounts (IRAs)

- Applicable to all IRA plans
 - Must have “earned income” to contribute (i.e. wages, commissions, self-employment income)
 - Contribute lesser of \$6000 or “earned income” (\$7000 if age 50 or older)
 - 10% Penalty for withdrawals before age 59 ½*

**See exceptions to penalty later*

Traditional IRAs

- Many are rollover IRAs from former jobs
- If NEITHER the taxpayer nor spouse are eligible to participate in an employer plan the allowable deduction is allowed, regardless of income
- If EITHER the taxpayer or spouse is eligible to participate in an employer plan there are limits on how much is DEDUCTABLE, BUT taxpayers can still CONTRIBUTE to a Traditional IRA regardless of income (aka a non-deductible traditional IRA).
- Must start withdrawing a minimum amount at age 72 (aka Required Minimum Distributions or RMDs)
- Withdrawals are taxable at taxpayer's marginal rate

Roth IRAs

- Roth contributions aren't deductible, BUT there ARE income limits to who can CONTRIBUTE to a Roth IRA
- 5-year holding period needed for qualified distributions
- No mandate to withdrawal at age 72
- Qualified withdrawals are tax-free

¹¹ More Info: Roth IRA vs. Traditional IRA: What's the Difference? Investopedia.

<https://www.investopedia.com/retirement/roth-vs-traditional-ira-which-is-right-for-you>

Penalties on early distributions (IRAs)

- Traditional IRAs and Roth IRAs have different withdrawal ordering rules that could impact penalties
- The tax code allows taxpayers to waive the 10% penalty for withdrawal before age 59 ½ under certain circumstances
- Employer Plans and IRAs have different exceptions to waive the 10% penalty

CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Gross distribution		OMB No. 1545-0119		Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
		\$		2021		
		2a Taxable amount				
\$		2b Taxable amount not determined <input type="checkbox"/>		Total distribution <input type="checkbox"/>		Copy C For Recipient's Records
PAYER'S TIN	RECIPIENT'S TIN	3 Capital gain (included in box 2a)		4 Federal income tax withheld		
		\$		\$		
RECIPIENT'S name		5 Employee contributions/ Designated Roth contributions or insurance premiums		6 Net unrealized appreciation in employer's securities		This information is being furnished to the IRS.
\$		\$				
Street address (including apt. no.)		7 Distribution code(s)		8 Other		
		IRA/SEP/SIMPL <input type="checkbox"/>		\$ %		
City or town, state or province, country, and ZIP or foreign postal code		9a Your percentage of total distribution %		9b Total employee contributions		
		\$		\$		
10 Amount allocable to IRR within 5 years	11 1st year of desig. Roth contrib.	12 FATCA filing requirement <input type="checkbox"/>	14 State tax withheld	15 State/Payer's state no.	16 State distribution	
\$			\$		\$	
Account number (see instructions)		13 Date of payment	17 Local tax withheld	18 Name of locality	19 Local distribution	
			\$		\$	
			\$		\$	

Form **1099-R** (keep for your records)

www.irs.gov/Form1099R

Department of the Treasury - Internal Revenue Service

Terminology

- Contributions: adding money to an account by sending cash, check, or direct payroll deferral
- Transfers: change custodians but same type of account (i.e. traditional IRA in one company to traditional IRA in another) – **no tax consequence**
- Rollovers: (change to different kind of account, but not tax character: i.e. pretax 401(k) → pretax traditional IRA) – **no tax consequence**
- Conversions: (change tax character: i.e. pretax traditional IRA to after tax Roth IRA) – **taxes due at conversion**

Tax Diversification Options

- Why consider Roth Options?
 - Conventional wisdom: tax rates in retirement will be lower than while working.
 - New reality: tax rates are at historic lows. There is a good chance they will increase in the future.
 - It's a way to hedge our bets.
- More buckets = more flexibility = more opportunity

Tax Diversification Example

- Assume Single person with \$500k balance in each a Traditional IRA and Roth IRA. At retirement withdrawal \$30K from each*

Item	Amount
Gross Income	\$60,000
Less Roth Distribution(non-taxable)	(\$30,000)
Adjusted Gross Income	\$30,000
Standard Deduction	(\$12,400)
Taxable Income	\$18,600
Tax	\$2,038

- That's an effective tax rate of 3.4%!
- Tax would have been \$6,488 if all had been taken from traditional IRA

¹⁷ More Info: [2020 Standard Deduction](#) and [2020 Tax Brackets](#)

*Social Security further complicates this scenario

Tax Diversification Strategies

- Divert your next raise to Roth 401(k) or 403(b) plan
 - Won't notice the difference in take-home pay
- Divert future contributions to Roth 401(k) or 403(b) plan
- Contribute to a Roth IRA (Assuming you are eligible)
 - Use tax refund to fund the account
 - Contributions allowed up to April 15 for previous year
- Convert some (not all) Traditional IRAs to Roths
 - This can be done over several years – pay tax in small increments

Other Tax Strategies

- Put higher risk / higher growth investments in Roths v. Traditional IRAs
 - Diversify across all your tax buckets (i.e. 70% stocks and 30% bonds)
 - Since Roths aren't taxable when withdrawn, put growth investments (stocks and mutual funds) in there because that portfolio will grow more – tax free!
- Back door Roth IRA (may go away soon)
- Roth IRA for children
 - Child needs earned income
 - Get children in the savings mindset
 - Can use for education without penalty

Other Tax Buckets

- Social Security
- Pension Plans
- 457 Plans
 - State and Local governments
 - No penalty if withdrawn before age 59 1/2
 - Big catch-up provision in last 3 years of retirement

Other Tax Buckets

- Self-Employment Plans (SEPs)
- Stocks, Mutual Funds, ETFs (Capital Gains Tax Rates)
- Bonds
- Health Savings Accounts (HSAs)
- 529 College Savings Plans
- Many others

Buckets = Flexibility = Opportunity

Tax Preparation Help – Types of Preparers

- Representation Rights
 - Attorneys
 - CPAs
 - Enrolled Agents
- Limited or No Representation Rights
 - Annual Filing Season Program Participants
 - Other PTIN Holders Tax Professionals

Tools and Tips

- IRS Tools
 - Where's my refund?
 - IRS Account
 - Find a tax professional
- Tips for upcoming tax season
 - Advanced Child tax credit
 - Cryptocurrency
 - Charitable contributions

Homework

- ~~Learn the tax code!~~
- Check your employer to see if they offer a Roth option
- Take inventory of your savings and retirement accounts
- Identify areas where diversification makes sense
- Speak to your IRA, 401(k), or 403(b) custodian about different tax vehicle options

Questions

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