Winds of Change

Author: Don Cloud

For over 20 years, Americans have used Roth IRA to save after-tax money for being used later without worrying about income taxes on distributions. These saving vehicles came into existence via the Taxpayer Relief Act of 1997. In the year 2000, taxpayers had already saved over $2.6 trillion inside of these accounts[1]. If the government were to change any of the rules on these retirement accounts it could have a huge impact on retirement planning as a whole.

The general thought behind using a Roth IRA is to purchase tomorrow's dollars with today's tax rates. Many Americans have used this retirement tool to reduce taxes in retirement, with the thought being they would be high taxes in the future. In the last two decades, taxes haven't consistently increased for retirees, but that depends on the asset makeup of each person in retirement. Others have used this tool to reduce or eliminate taxation on their Social Security benefits by reducing their taxable income with distributions from their Roth IRA accounts. Over the past 20 years, I have seen multiple ways investors and planners have used these tax-advantaged tools to manipulate retirees' incomes in favor of the individual. Coupled with the fact that Roth retirement accounts are not forced to take the required minimum distribution at age 72, they can also be a valuable estate planning tool.

In September the House Ways and Means approved a proposed plan that would have lead to several changes to IRA and 401(k) retirement accounts. In particular, this would spell the end of the backdoor Roth and mega backdoor Roth strategies. This would have mostly began in 2022. Under the current law system, you can get around the Roth IRA income limits by doing the backdoor Roth IRA strategy. A backdoor Roth IRA is when you make after tax contributions to a traditional IRA and convert it to a Roth IRA. Since anyone with earned income can contribute to a Traditional IRA, this allows you to go around the Roth income limits. You pay the taxes you owe on that money right away. But the investments then grow tax-free[2]. Wrapped up in the plan were several other changes, but these would have had the most impact to Roth savers. Thankfully in November 2021 the proposed changes were dropped from the Pending Reconciliation Bill Build Back Better Act of 2021.

Those proposed changes caused some to have anxiety about how this would affect their current plans. If we have learned anything, speculation is best left to speculators, and financial planning is best left to facts. Not all plans put forth by legislators come to fruition. If proposed changes can affect your retirement plan, it is best to have a backup plan to address any proposed changes. Doing this allows you to see the outcome of both scenarios, and usually, that alone can alleviate some of the anxiety from proposed changes coming from Washington.

References

1 https://en.wikipedia.org/wiki/Roth_IRA

2 https://districtcapitalmanagement.com/proposed-changes-to-retirement-plans/