MANAGEMENT & *TAX CONCEPTS*

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BEWARE THE FIVE-YEAR RULE

Understanding Roth IRA withdrawals

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Beware the five-year rule

Understanding Roth IRA withdrawals

What makes Roth IRAs so appealing? Primarily, it's the ability to withdraw money from them tax-free. But to enjoy this benefit, there are a few rules you must follow, including the widely misunderstood "five-year rule."

3 TYPES OF WITHDRAWALS

To understand the five-year rule, you first need to understand the three types of funds that may be withdrawn from a Roth IRA:

1. *Contributed principal*, which is your after-tax contributions to the account,
2. *Converted principal*, which consists of funds in a traditional IRA that you convert to a Roth IRA, and
3. *Earnings*, which includes interest and profits on contributed or converted principal.

Generally, you can withdraw contributed principal at any time without taxes or early withdrawal penalties, regardless of your age or how long the funds have been held in the Roth IRA. But to avoid taxes and penalties on withdrawals of earnings, you must meet two requirements: 1) the withdrawal must not be made before you turn 59½, die, become disabled or qualify for an exception to early withdrawal penalties (such as withdrawals for qualified first-time homebuyer expenses); and 2) you must satisfy the five-year rule. Converted principal isn't taxable, since you're taxed at the time of the conversion, but it's subject to early withdrawal penalties if you fail to satisfy the five-year rule.

FIVE-YEAR RULE

As the name suggests, the five-year rule requires you to satisfy a five-year holding period before you can withdraw Roth IRA earnings tax-free or converted principal penalty-free. But the rule works differently depending on the type of funds you're withdrawing.

If you're withdrawing earnings, the five-year period begins on January 1 of the tax year for which you made your first contribution to *any* Roth IRA. For example, if you opened your first Roth IRA on

April 1, 2017, and treated your initial contribution as one for the 2016 tax year, then the five-year period started on January 1, 2016. That means you were able to withdraw earnings from *any* Roth IRA tax- and penalty-free beginning on January 1, 2021 (assuming you were at least 59½ or otherwise exempt from early withdrawal penalties). Note: If you're not subject to early withdrawal penalties (because, for example, you're 59½ or older), failure to satisfy the five-year rule won't trigger a penalty, but earnings will be taxable.

If you're withdrawing converted principal, the five-year holding period begins on January 1 of the tax year in which you do the conversion. For instance, if you converted a traditional IRA into a Roth IRA at any time during 2017, the five-year period began January 1, 2017, and ends December 31, 2021. Unlike earnings, however, each Roth IRA conversion is subject to a separate five-year holding period. If you do several conversions over the years, you'll need to track each five-year period carefully to avoid triggering unexpected penalties. Keep in mind that the five-year rule only comes into play if you're otherwise subject to early withdrawal penalties. If you've reached age 59½, or a penalty exception applies, then you can withdraw converted principal penalty-free even if the five-year period hasn't expired.

You may be wondering why the five-year rule applies to withdrawals of funds that have already been taxed. The reason is that the tax benefits of Roth and traditional IRAs are intended to promote long-term saving for retirement. Without the five-year rule, a traditional IRA owner could circumvent the penalty for early withdrawals simply by converting it to a Roth IRA, paying the tax, and immediately withdrawing it penalty-free. Note, however, that while the five-year rule prevents this, it's still possible to use a conversion to withdraw funds penalty-free before age 59½. For example, you could convert a traditional IRA to a Roth IRA at age 45, pay the tax, wait five years and then withdraw the converted principal penalty-free.

Ordering rules may help avoid costly mistakes

The consequences of violating the five-year rule can be costly, but fortunately there are "ordering rules" that help you avoid inadvertent mistakes. Under these rules, withdrawals from a Roth IRA are presumed to come from after-tax contributions first, converted principal second and earnings third.

So, if contributions are large enough to cover the amount you wish to withdraw, you will avoid taxes and penalties even if the five-year rule hasn't been satisfied for converted principal or earnings. Of course, if you withdraw the entire account balance, the ordering rules won't help you.

WHAT ABOUT INHERITED ROTH IRAs?

Generally, one who inherits a Roth IRA may withdraw the funds immediately without fear of taxes or penalties, with one exception. The five-year rule may still apply to withdrawals of *earnings* if the original owner of the Roth IRA hadn't satisfied the five-year rule at the time of his or her death.

For instance, suppose you inherited a Roth IRA from your grandfather on July 1, 2021. If he made his first Roth IRA contribution on December 1, 2018, you'll have to wait until January 1, 2023, before you can withdraw earnings tax-free.

HANDLE WITH CARE

Many people are accustomed to withdrawing retirement savings freely once they reach age 59½. But care must be taken when withdrawing funds from a Roth IRA to avoid running afoul of the five-year rule and inadvertently triggering unexpected taxes or penalties. The rule is complex — so when in doubt consult a tax professional before making a withdrawal. •

What's in your company's financial statement?

There are many indicators you can evaluate to get a sense of the financial health of your business, so it's easy to overlook one of the most important: your company's financial statement. Getting a handle on the balance sheet, income statement and statement of cash flows can help you ensure that you make decisions based on sound financial information.

THE HEALTH OF YOUR BUSINESS

On the balance sheet, your company's assets, liabilities and net worth are tallied to create a snapshot of its financial health.

Net worth, or owners' equity, is the extent to which assets exceed liabilities. If the value of liabilities exceeds the value of assets, net worth will be negative. There are a number of balance sheet ratios worth monitoring, including:

Growth in accounts receivable compared to growth in sales. If receivables are growing faster than the rate at which sales are increasing, customers may be taking longer to pay. They may be running into financial trouble, or finding quality issues with the products or services.

Growth in inventory vs. growth in sales. When inventory levels increase at a faster rate than sales, the company is producing products faster than they're being sold. This can tie up cash. Moreover, the longer inventory remains unsold, the greater the likelihood it will become obsolete.

Growing companies often must invest in inventory and accounts receivable, so increases in these accounts don't always signal problems. Typically, jumps in inventory or receivables should correlate to rising sales.

Ratio of current assets to current liabilities. If this ratio falls below 1, the company may struggle to pay bills coming due. Some business experts believe a current ratio of less than 2:1 is problematic.

THE IMPORTANCE OF INCOME

The income statement shows sales, expenses, and the income or profits earned after expenses over a given period. A commonly used term when discussing income statements is "gross profit," or the income earned after subtracting the cost of goods sold from revenue. Cost of goods sold includes the cost of labor and materials required to make a product. Another important term is "net income," which is the income remaining after all expenses (including taxes) have been paid.

Like the balance sheet, the income statement can reveal potential

When inventory levels increase at a faster rate than sales, the company is producing products faster than they're being sold.

problems. It may show a decline in gross profits, which means production expenses are rising more quickly than sales.

CASH FLOWS MATTER

A statement of cash flows shows all the cash flowing into and out of your company. For example, your company may have cash inflows from selling products or services, borrowing money and selling stock. Outflows may result from paying expenses, investing in capital equipment and repaying debt.

Although this report may seem similar to an income statement, its focus is solely on cash. For instance, a product sale might appear on the income statement even though the customer won't pay for it for another month. But the money from the sale won't appear as a cash inflow until it's collected. To remain in business, companies must continually generate cash needed to pay creditors, vendors and employees. So, you should watch your statement of cash flows closely.

HEAD OFF POTENTIAL PROBLEMS

Each of these reports contains different indications of whether your business is operating profitably or whether there are money issues lurking that need to be addressed. Staying on top of the information the financial statement provides can help you head off problems before they seriously impact your company's financial health. •

Go electronic: Digitize your important documents

We all leave a paper trail of financial records and tax documents. But as the trail grows longer and space runs out, paper becomes increasingly cumbersome. For both practical and environmental reasons, it may be time to consider other forms of document storage. In an age where nearly all facets of life are digitized, why not consider electronic storage of your important documents? If done properly, it can be a safe and efficient way to "keep" documents secure, even absent hard copies.

WHAT ARE THE BENEFITS?

There are many potential benefits to electronic document storage. Perhaps the biggest is a reduction in the amount of paper that must be sorted, organized and stored manually. Also, you can conduct a keyword search for documents that reside in an electronic filing cabinet. That's, of course, better than manually searching for paper documents that may or may not have been filed correctly.

Documents stored digitally tend to be more secure than paper documents. Electronic filing cabinets

can be password protected. And they aren't as vulnerable to damage or destruction by floods, fire or other disasters — especially when you back them up on the cloud.

In addition, electronic documents can be digitally date-stamped, which helps ensure that you're accessing the most recent versions. You can easily track edits to electronic files, monitor who's been viewing them and restrict access to sensitive documents.

Electronic filing cabinets usually work in tandem with a scanner, which is used to convert paper documents into digital versions such as PDF files. Most paper documents can be shredded once they've been digitized. However, you may want to retain paper versions of estate planning documents such as wills and trusts.

WHAT IS THE BEST SYSTEM FOR YOU?

There are two main types of electronic document storage: web-based systems and self-hosted systems. Web-based systems use the internet to store documents in the cloud. Self-hosted systems store documents on a computer, external hard drive or portable drive (such as a USB thumb drive) kept in the home or office. Each option has advantages and drawbacks.

Web-based systems tend to be highly secure — data storage facilities typically use the most sophisticated encryption technologies to keep your files safe. Cloud storage is also inexpensive. For example, up to 50 gigabytes of data can be stored on iCloud for 99 cents per month. But, if your hosting service is interrupted for any reason, you could lose access to your files for a period.

With a self-hosted system, you'll be responsible for storing documents on your own computer or hard drive. This eliminates the chance that a lost internet connection or service interruption at your host could restrict access to your files. But you also run the risks of a computer crash, computer or hard drive damage due to a fire or flood, or loss of a flash drive.

If any of these happen, all your files could be lost if they're not backed up properly. Regular, periodic backups are essential.

Whether self-hosted or web-based, it's also a good idea to be sure that at least one other person knows how to access your information. That way it'll still be available even if you become incapacitated or are otherwise unable to retrieve the data.

WHY NOT LET TECHNOLOGY DO THE WORK?

Filing and storing important documents can be an onerous task if you rely solely on paper. By following these pointers for establishing an electronic storage system, you can rest assured that your digitized documents are safe and protected over the long term. •

How to avoid the federal cap on SALT deductions

In 2017, the Tax Cuts and Jobs Act placed a $10,000 cap on deductions of state and local taxes (SALT), effective through 2025. That cap substantially reduces itemized deductions for many taxpayers in states with high income taxes. Since that time, state legislatures have come up with a variety of creative workarounds designed to help taxpayers in their states circumvent the SALT cap. The IRS put the kibosh on many of these workarounds, but one has emerged as a potential solution: an entity-level state tax on pass-through entities (PTEs), such as partnerships, S corporations and LLCs.

In Notice 2020-75, the IRS gave its blessing to this approach, though the viability of a particular state's law will depend on the terms of forthcoming regulations on the subject. In response, more than a dozen states so far have enacted PTE taxes and several others are considering following suit.

> *Note that owners in lower tax brackets may end up paying more tax under a PTE tax regime.*

The mechanics of PTE taxes vary from state to state, but the general approach is the same: The state imposes an optional or mandatory tax on PTEs that are located in the state, do business there or otherwise are required to file an income tax return with the state. The entity-level tax is generally applied at the top individual income tax rate (though some states use a lower rate) to the owners' pro rata or distributive shares of the entity's net income. Essentially, this shifts state income tax liability from the owners to the entity, but the entity-level tax is fully deductible as a business expense, circumventing the SALT cap. Owners receive a corresponding credit to offset their shares of the entity's tax liability.

If the PTE tax is designed properly, the result should be roughly the same as if the owners had paid the taxes themselves and then fully deducted them on their individual federal income tax returns with no limit. Note, however, that owners in lower tax brackets may end up paying more tax under a PTE tax regime. That's why some states permit these owners to opt out of the PTE tax.

If you're a PTE owner, check to see if the states in which you do business have enacted a PTE tax. If they have, there may be an opportunity to bypass the limit on SALT deductions and substantially reduce your tax bill. •

TAX PLANNING AND PREPARATION

Taxes are a part of life, and at Martin Hood we can help you find ways to minimize the impact that taxes have on you and your family. We work with our clients year-round to develop and implement effective tax planning strategies to reduce year-end tax bills. Our state and international tax team performs extensive research in areas that reach beyond our local community. In addition to income tax preparation, we can prepare gift and estate tax returns, sales and payroll tax returns, and informational tax returns for not-for-profit organizations. We also assist clients with IRS audits and notices from tax authorities.

BUSINESS ADVISORY SERVICES

We provide accounting assistance and a comprehensive approach to helping with whatever keeps you up at night. We can help set up an accounting system to help you cover your accounting needs on your own in a more efficient manner, fill a temporary need for accounting staff, or fill a more permanent role in basic accounting or acting as an outsourced controller — all while keeping the bigger picture in mind and pulling in our tax, assurance, and planning expertise to serve as a well-rounded business advisor in nearly all tax, accounting, and financial matters.

ESTATE AND RETIREMENT PLANNING

The Estate and Retirement Planning team at Martin Hood helps our clients recognize the importance of proper planning for business succession, education, retirement, and wealth accumulation. This process is presented in an open and candid manner, placing family and retirement needs at the forefront of every plan. Our team strives to help you build a plan that minimizes the estate tax burden and helps you achieve your financial goals.

Tax Specialty Areas

- State and Local Taxation
- International Tax Issues
- Trusts and Estates
- Partnerships
- C corporations
- S corporations
- Individual tax compliance
- Tax planning
- Construction and Manufacturing
- Non-profits