KRAMER & JENSEN LLC
CERTIFIED PUBLIC ACCOUNTANTS

Contact Us:

Kramer & Jensen LLC
7430 E. Caley Ave. Suite 300E
Centennial, CO 80111
T 303-741-2253
F 855-330-4215
sjensen@kramerjensen.com

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Is This an Opportune Time to Convert Your Traditional IRA to a Roth IRA?

If your traditional IRA is invested in stocks and/or mutual funds, the recent substantial downward slide by the stock markets may provide a unique opportunity to convert your traditional IRA to a Roth IRA at a low cost, and then benefit when the markets recover.

Why would you want to do that? Because Roth IRA distributions provide tax free retirement benefits while payouts from Traditional IRAs are taxable.

Of course there is no assurance that the markets will not continue to decline, and this may not be the most opportune time to make a conversion in your specific circumstances but is something you may want to consider. Conversions provide the most benefit to younger individuals who can look forward to many years of the tax-free growth provided by a Roth IRA.

You don't have to convert all of your traditional IRA in one year. You can convert what you can afford to pay the tax on each year.

Here Is How It Works – The tax code allows individuals to convert any portion of their traditional IRA to a Roth IRA by paying tax on the conversion as though taking a distribution from the traditional account. Thus, if you make a conversion you are taxed on the conversion based upon the tax rates that apply to your normal income plus the traditional IRA amount being converted.

Of course, if in 2022 you have abnormally lower income, that could make the conversion tax even less. The following table includes the marginal tax rates for 2022.

MARGINAL TAX RATES					
Year	Marginal Rate	FILING STATUS			
		Single	HH	MFJ	MFS
2022	10.0%	10,275	14,650	20,550	10,275
	12.0%	41,775	55,900	83,550	41,775
	22.0%	89,075	89,050	178,150	89,075
	24.0%	170,050	170,050	340,100	170,050
	32.0%	215,950	215,950	431,900	215,950
	35.0%	539,900	539,900	647,850	323,925
	37.0%				

Example When Using the Table - Let's say you are filing single and your taxable income without an IRA conversion amount is $45,000, which has a marginal rate of 12%, and you are converting $40,000. This brings your taxable income to $85,000, which is still in the 12% bracket (it's more than $41,775 but less than $89,075, the start of the next rate). This means the tax on the conversion would be $4,800 (12% of $40,000). If you did the conversion in a year when your other income was more and when combined with the conversion amount you are in the 22% bracket, the tax on the conversion would be $8,800, $4,000 more than when you are in the 12% bracket.

Other Issues:

- There is no income limitation on making a conversion, thus anyone can do a conversion.
- Higher income taxpayers can use the conversion to circumvent the AGI limits for contributing to a Roth IRA.
- Once a conversion is made it cannot be undone.
- Some individuals for various reasons have made non-deductible contributions to their traditional IRAs. For distribution or conversion purposes, all an individual's IRAs (except Roth IRAs) are considered as one account and any distribution or converted amounts are deemed taken ratably from the deductible and non-deductible portions of the traditional IRA, and the portion that comes from the deductible contributions would be taxable.

Give this office a call if you would like to explore the possible benefits of a traditional to Roth IRA conversion.

Not All Interest Is Deductible for Taxes

A frequent question that arises when borrowing money is whether or not the interest will be tax deductible. That can be a complicated question, and unfortunately not all interest an individual pays is deductible. The rules for deducting interest vary, depending on whether the loan proceeds are used for personal, investment, or business activities. Interest expense can fall into any of the following categories:

- *Personal interest* – is not deductible. Typically this includes interest from personal credit card debt, personal car loan interest, home appliance purchases, etc.
- *Investment interest* – this is interest paid on debt incurred to purchase investments such as land, stocks, mutual funds, etc. However, interest on debt to acquire or carry tax-free investments is not deductible at all. The annual investment interest deduction is limited to "net investment income," which is the total taxable investment income reduced by investment expenses (other than expenses related to investments that produce non-taxable income). The investment interest deduction is only allowed to taxpayers who itemize their deductions.
- *Home mortgage interest* – includes the interest on debt to purchase, construct or substantially improve a taxpayer's principal home or second home. This type of loan is referred to as acquisition debt. For the interest to be deductible the debt must be secured by the home purchased, constructed, or substantially improved. A secured debt is one in which the taxpayer signs a mortgage, deed of trust, or land contract that makes their ownership in a qualified home security for payment of the debt; provides, in case of default, that the home could satisfy the debt; and is recorded under any state or local law that applies. In other words, if the taxpayer can't pay the debt, their home can then serve as payment to the lender to satisfy the debt.
    - For Debt Incurred Before 12/16/2017 - the debt for which the interest is deductible is limited to $1,000,000 ($500,000 for married separate).
    - For Debt Incurred After 12/15/2017 - the debt for which the interest is deductible is limited to $750,000 ($375,000 for married separate).
- *Passive activity interest* – includes interest on debt that's for business or income-producing activities in which the taxpayer doesn't "materially participate" and is generally deductible only if income from passive activities exceeds expenses from those activities. The most common passive activities are probably real estate rentals. For rental real estate activities, there is a special passive loss allowance of up to $25,000 for taxpayers who are active but not necessarily material participants in the rental. The $25,000 phases out for taxpayers with adjusted gross income between

$100,000 and $150,000.

- *Trade or business interest* – includes interest on debts that are for activities in which a taxpayer materially participates. This type of interest can generally be deducted in full as a business expense.

Because of the variety of limits imposed on interest deductions, the IRS provides special rules to allocate interest expense among the categories. These "tracing rules," as they are called, are generally based on the use of the loan proceeds. Thus interest expense on a debt is allocated in the same manner as the allocation of the debt to which the interest expense relates. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures, i.e., "follow the money."

These tracing rules, combined with the restrictions associated with the various categories of interest, can create some unexpected results. Here are some examples:

- **Example 1:** A taxpayer takes out a loan secured by his rental property and uses the proceeds to refinance the rental loan and buy a car for personal use. The taxpayer must allocate interest expense on the loan between rental interest and personal interest for the purchase of the car, and even though the loan is secured by the business property, the personal loan interest portion is not deductible.

- **Example 2:** The taxpayer borrows $50,000 secured by his home to be used in his consulting business. He deposits the $50,000 into a checking account he only uses for his business. Since he can trace the use of the funds to his business, he can deduct the interest as a business expense.

- **Example 3:** The taxpayer owns a rental property free and clear and wants to purchase a home to use as his personal residence. He obtains a loan on the rental to purchase the home. Under the tracing rules, the taxpayer must trace the use of the funds to their use, and as the debt was not used to acquire the rental, the interest on the loan cannot be deducted as rental interest. The funds can be traced to the purchase of the taxpayer's home. However, for interest to be deductible as home mortgage interest, the debt must be secured by the home, which it is not. Result: the interest is not deductible anywhere.

As you can see, it is very important to plan your financing moves carefully, especially when equity in one asset is being used to acquire another. Please call this office for assistance in applying the various interest limitations and tracing rules to ensure you don't inadvertently get some unexpected results.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

Scott Jensen
Kramer & Jensen, LLC

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Kramer & Jensen, LLC
sjensen@kramerjensen.com

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