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# OnWatch

## *In This Issue:*

**Mega Backdoor Roth 401(k) Strategy**
*By Brandon D. Harsell, CPA*

**Is Long-Term Care Insurance Right for Me?**
*By Kelsey W. Gray, JD*

**Condo Considerations**
*By Lissa S. Gangjee, JD, CFP®*

# *Mega Backdoor* ROTH 401(K) STRATEGY

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A Roth IRA can accumulate income and gains tax-free, potentially for decades, and subsequently distribute them to you or your heirs without income tax.

The problem is that annual contributions to a Roth IRA are limited to $6,500 ($7,500 if over age 50). It's hard for a wealthy person to get very excited about such a paltry amount, especially since the contribution is not deductible if a married couple has adjusted gross income exceeding $218,000 ($138,000 for a single person). However, through a little-known strategy called a "Mega Backdoor Roth" (MBR), some employees can add up to $44,000 to a Roth IRA during 2023 via their employer-sponsored 401(k) plans. Although the contributions are not deductible, avoiding future income taxes on the earnings could save tens of thousands of dollars, and perhaps much more if the strategy is repeated in future years.

***About Sentinel Trust Company***

*Sentinel Trust Company, LBA is an independent wealth management firm and multi-family office that provides comprehensive wealth and succession planning, fiduciary, investment management, philanthropic, and family office services to a select group of affluent families and their closely held entities and foundations. Founded in 1997 as the successor to two 40-plus-year-old single-family offices, Sentinel Trust currently serves more than 30 multi-generational families nationwide and is responsible for approximately $5.5 billion in assets as of December 31, 2022.*

***Learn more at***
*www.sentineltrust.com.*

# THE BACKDOOR ROTH

The better-known "Backdoor Roth" strategy provides the conceptual foundation for the MBR (Mega-Backdoor Roth). It allows an individual to make an indirect Roth contribution when his income is too high to make a direct Roth contribution. To execute the Backdoor Roth strategy, you open a traditional IRA and contribute up to $6,500 ($7,500 if you are over age 50). Because the contribution is not deductible, you'll have a basis equal to the contribution amount. Immediately after making the contribution, you execute an IRA-to-Roth conversion. Typically, an IRA-to-Roth conversion results in taxable income equal to the conversion amount. However, since the non-deductible contribution generates a basis equal to the value converted, there is zero taxable income. The end result is a Roth IRA with the benefit of future earnings being income-tax free.

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## *Background Rules and Requirements*

The MBR is similar to the Backdoor Roth strategy (see sidebar), but is available to employees whose employer-sponsored 401(k) plans permit:

- after-tax (non-deductible) contributions in excess of the deductible limits ($22,500, plus an additional $7,500 if over age 50).
- in-service distributions to a Roth IRA. In-service distributions are withdrawals while still employed.

There are overall retirement plan contribution limits. In 2023, the limit is $66,000 ($73,500 if age 50 or older). Only $22,500 ($30,000 if age 50 or older) of this limit can be made on a pre-tax basis; the balance is after-tax. The limit applies to all 401(k) (including employer-matching), IRA, and any other retirement plan contributions.

401(k) plans are subject to the pro-rata rule, which states that distributions generally are deemed to be made pro-rata from pre-tax and after-tax contributions (and earnings thereon) in your 401(k) account. To avoid being taxed on a portion of the in-service distribution aspect of the MBR, your employer must separately track the pre-tax and after-tax portions of your 401(k) account.

## *Example of the MBR Strategy*

Bill is under 50, so his 2023 retirement contributions are capped at $66,000. He maximizes his pre-tax 401(k) contribution at $22,500 and his employer contributes $4,000 as a match. Bill makes a $6,500 non-deductible contribution to an IRA and coverts it to a Roth via the Backdoor Roth strategy (see sidebar). Bill can contribute up to $33,000 ($66,000 – $22,500 – $4,000 – $6,500) as an after-tax contribution to his 401(k) plan. Assuming his employer tracks the before- and after-tax portions of the 401(k) account, he can roll the $33,000 to a Roth IRA via an in-service distribution. The end result is $26,500 ($22,500 + $4,000) in his pre-tax 401(k) account and $39,500 ($33,000 + $6,500) in his Roth IRA.

401(k) plans are subject to non-discrimination testing, which ensures highly compensated employees are not disproportionately benefiting from the retirement plan when compared to non-highly compensated employees. An MBR contribution could cause the 401(k) plan to fail the non-discrimination testing. Your plan administrator must ensure that you stay within the testing boundaries.

The MBR strategy is an effective way for wealthy individuals to supercharge retirement plan contributions. However, there are numerous moving parts, so you should implement the strategy in consultation with your 401(k) plan administrator and your professional tax advisor.

## *Tax Efficient IRA-to-Roth Conversion*

Negative stock market years like 2022 are tough for investors, but there can be silver linings. An IRA-to-Roth conversion can be compelling in down years, especially if your taxable income is lower than usual, because you can convert IRA funds at a lower tax rate. Hopefully markets recover after the conversion thereby resulting in much higher post-conversion Roth asset values. There are no income limits for conversions, which can make them attractive for wealthy individuals, especially if they are able to implement an intelligent conversion strategy.

**Neither IRAs nor Roth IRAs tax earnings, but there are important differences:**

- Qualified distributions from Roths are generally income tax free, while such distributions from IRAs are taxable.
- Roth IRAs do not require minimum distributions, while IRAs must distribute when the owner reaches a specified age (generally age 73). That reduces the time period in which earnings within the account can grow without tax. While both vehicles can pass to your surviving spouse, passage to your descendants generally requires that they receive distributions of the balance over 10 years. However, while descendants are subject to income tax on those distributions from an IRA, such distributions from a Roth are not hit with an income tax. Both are subject to estate taxation.

An IRA-to-Roth IRA conversion is taxable as ordinary income in the year of conversion. Wealthy taxpayers often have taxable income above the threshold ($693,750 for married couples in 2023) for the 37% top tax rate. The high tax rate can make an IRA-to-Roth conversion seem especially unattractive, unless you expect future rates to be even higher (e.g., if Congress and the President can agree to doing so and/or you contemplate moving to a state with a higher income tax).

However, suppose your taxable income is low in 2023 due to lack of capital gains, flat business income, low trust distributions, etc. If your taxable income is projected to be $200,000, your federal income tax would be $34,800. If you convert $493,750 of your IRA to a Roth IRA, you'd incur total income tax of $186,242, for an increase of $151,442. However, if you convert the same amount when your top tax rate is 37%, your tax on the conversion would increase $31,246 to $182,688. While you can avoid the conversion tax, your RMDs will result in the interim earnings becoming taxable upon distribution, which becomes particularly costly if you are in the 37% bracket in those later years.

When considering a conversion, talk with your professionals before moving funds. There are additional considerations, including other potentially tax-efficient strategies for regular IRAs, like funding charitable objectives by making up to $100,000 per year of RMDs to charity and passing all or part of the balance to charity at death. Those discussions, combined with tax projections, can lead you to the most tax-efficient decisions.

# IS LONG-TERM CARE INSURANCE *Right for Me?*

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Long-term care (LTC) insurance provides financial assistance when a person becomes unable to care for themselves generally due to age, chronic disabilities or long-term illness. It covers activities related to daily personal care, or what LTC insurance policies describe as "activities of daily living." According to the Centers for Medicare and Medicaid Services, activities of daily living include bathing or showering, dressing, eating, getting in and out of a bed or chair, toileting and walking.

Long-term care is not one-size-fits-all and policies differ in their terms, coverage, and payout amounts. Care can be provided at home, in an assisted-living facility or a nursing home. If a person chooses in-home care, coverage can include assistance with household chores and meal preparation. Although Medicare may cover some skilled-nursing care and assistance with recovery from a medical condition, it does not cover long-term care; hence the possible need for a private LTC policy. LTC insurance benefits supplement your social security and disability benefits.

It can be hard to determine whether LTC insurance is worth the cost. Surprisingly, the healthier you are, the more likely you are to need LTC. Why? Statistically, most claims against LTC insurance policies are made by insureds aged 80 to 85, and healthy people are more likely to live longer. Insurance companies now have mortality charts that run to age 125 and policies are priced with increasing life expectancies in mind.

LTC insurance is expensive. As a rule of thumb, it often is considered most appropriate for people with liquid assets between $5-15 million. "Wealthier" people (e.g., over $15 million) might be able to afford retirement and LTC costs. "Poorer" people (e.g., under $5 million) are unlikely to be willing to incur the high LTC premiums. They might expect to spend down their assets in retirement, and then qualify for and rely upon Medicaid to cover any LTC needs. Those in between might be willing to incur LTC premiums to reduce the risk of running out of funds in retirement and avoid relying upon Medicaid as a backstop.

## *When to Buy?*

Like life insurance policies, a person's age and health can affect the price of the LTC policy. It can be beneficial to consider purchasing a policy at a younger age rather than waiting until care needs are right around the corner. A 50-year-old male in good health might pay premiums of less than $4,000 a year for a high quality, 4% compounded inflation-adjusting policy. The most cost-efficient age for purchasing coverage is around 50 years old. Most people purchase coverage between ages 50 and 65. Health matters, too. An individual already unable to perform some or all activities of daily living may not even be accepted for LTC insurance coverage.

## *Important Factors to Consider when Shopping for a Policy*

**Consider the following when shopping for a LTC insurance policy:**

- **Taxability –** Nearly all plans are tax-qualified, meaning the benefits received are tax-free regardless of other income.
- **Daily Benefit Amount –** The daily benefit amount is the maximum amount the LTC policy will pay for each day of care even though actual expenses may be greater.
- **Maximum Policy Benefits –** Some policies have a maximum lifetime policy benefit, potentially leaving you without further coverage.
- **Inflation Protection –** This provision can be critical in the face of potential inflation in cost. It should be considered both with regard to daily and lifetime benefit amounts. For example, a policy with a $100 daily benefit and 5% compounded inflation protection, will double to $200 per day in 14 years. Without this protection, that same benefit will only be worth half its original value in 14 years, and the insured must pay the difference in the cost of care.
- **Guaranteed Renewable –** A guaranteed renewable policy must be renewed by the insurance company as long as the premiums are paid on time. This means a person's age and changing health will not impact the policy renewal.
- **Duration of Benefits and Benefit Triggers –** Policies typically limit coverage to a specified number of months (e.g., 12 months) of care. Generally, the longer the duration of benefits, the more expensive the premium will be. It also is important to understand when the policy will come into effect. Benefits can be triggered when a person is unable to perform a defined number of activities of daily living.

A LTC policy can provide substantial peace of mind, but it is not appropriate for everyone. You would be well-advised to consult with an experienced advisor who can consider your unique personal circumstances to help you weigh the pros and cons. ■

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# *Condo* CONSIDERATIONS

If you're thinking about buying a condo, it's important to know what to expect. A condo is a privately owned residential unit within a residential complex that can be anything from an old, converted apartment complex to a new, ritzy high-rise building. A condo can be a primary residence, but also can be a good choice as a second home or investment property in a popular holiday destination like Florida or Hawaii, or in expensive cities like New York City, San Francisco or Washington, D.C. If you don't have the time or inclination to hassle with home upkeep, particularly the outdoors, and want to be able to "lock and leave" when you travel, a condo can be the ideal low-maintenance option.

Similar to a homeowners association (HOA), condos have a condo owner association (COA) that dictates what residents can, and cannot, do with certain common spaces—typically the exterior building walls, grounds, and other shared areas like pools, gyms and other amenities. The COA typically is responsible for managing and insuring the building and common areas, while you are responsible for insuring you unit's personal contents, like furniture, clothing, electronics, artwork and jewelry. The COA charges a monthly fee to cover its responsibilities and can assess additional fees if reserves are insufficient to cover costs. These fees can be high, ranging from hundreds to thousands of dollars, potentially making the cost of living in a condo equivalent to paying for a single-family home. The COA rules can seem overly restrictive, making the property less attractive if you're the kind of person who enjoys freedom and individuality. Expect restrictions on car parking, additions or changes to the exterior (including holiday decorations), noise limitations (both inside your residence and in common areas) and more.

While a condo owner typically owns the space within her unit, the actual building, land and common areas are usually owned by the COA. The COA is owned by you and your fellow condo owners, so you have a financial stake in the building in addition to the unit you purchased. The COA board is typically made up of condo owners. It holds regular meetings to discuss property maintenance, fees, and other items of concern; and all owners have a vested interest in ensuring the building and grounds remain in good condition.

**Beyond that, here are some important factors to consider before taking the condo plunge:**

- Monthly COA dues usually cover landscaping, regular maintenance, management fees and any clubhouse amenities such as: pool, spa, workout room/gym, security, common area utilities and insurance. It is extremely important for the COA to build adequate reserves to cover infrequent major expenses like roof and siding replacement, parking lot repair and replacement, pool issues and property defects. Ask to see the seller's monthly dues history covering at least the past two years. You should expect to see the dues increase slightly year over year. You don't want to see big spikes or no increases — both could indicate that monthly dues may be held unreasonably low and, therefore, may be insufficient to build reserves. Well-run COAs engage consultants to analyze reserves and create financial models for future major-cost needs. You should ask to examine these studies.

- The COA bylaws and covenants, conditions, and restrictions (CC&Rs) govern life in a condo owners' association. Simply put, they regulate the use, maintenance, and appearance of residents' property. As far as rules and restrictions of the neighborhood are concerned, you'll want to make sure there is nothing that is unacceptable to you.

- Ask to see the last two years of COA meeting minutes. By reviewing the minutes, you'll be able to decipher if there is any ongoing conflict within the association. You may also be able to review the COA's website for insights into what the owners are saying/griping about. Talk to residents of neighboring units. If possible, ask about whether there are noise or other problems either inside or outside of their units.

- Try to get a sense as to the percentage of leased vs. owner-occupied units. As a general rule, properties that are primarily owner occupied tend to be better maintained.

- Ask whether the COA engages a property management company to help guide the association. Professional management and operation often is better than a property that is run solely by private individuals. ■

Sentinel Trust Company is a family-owned, multi-family office focusing on the unique needs of affluent families and their closely held companies and foundations. Sentinel Trust provides advice on investment, tax, and estate strategies, serves as corporate trustee, and provides lifestyle services with a personal touch.

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Founded in 1997 as the successor to two established, investment-focused single family offices, Sentinel Trust offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office, and the in-house technical skills of independent planning and investment management firms.

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