The benefits of being tax smart throughout the year

TRANSCRIPT

SPEAKERS:

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COLLEEN ROLPH: Hello and welcome. I'm Colleen Rolph, Vice President of Learning in the Personal Investing division at Fidelity Investments. My focus is to engage customers like you in their finances across our workplace and personal investing business. We're thrilled you joined us today. I'm here with Chris Williams from Ernst & Young. Welcome, Chris.

CHRIS WILLIAMS: Thanks for having me.

CR: Yeah, thrilled you could be here. So at Ernst & Young, Chris focuses on advising clients on income tax planning and preparation, estate and business succession planning, and tax authority examinations. He also works with Ernst & Young offices around the world—very jealous of that (laughter)—to assist cross-border individuals with their U.S. and foreign income tax compliance, tax planning, and wealth transfer planning needs. Chris, again, thanks so much for coming. We've got a lot to share with our viewers today. And in particular, can you elaborate on the three things that we're going to touch on for them?

CW: Sure. We'll focus primarily today on IRAs and how they fit into retirement planning, talk a little bit about 529 plans and how they can fit into your education planning strategy, and then also state taxes. We talk a lot about federal taxes, but want to focus today a little bit on state tax rules and state residency planning.

CR: Okay, so retirement, college, and state taxes and how you take that into consideration. So before we jump in, please keep two items in mind. It's important to have a plan in place that addresses taxes, particularly if the majority of your assets are in taxable accounts. The fact is,

taxes can have a significant impact on your investment returns at any stage of your investing life. We encourage you to speak with your tax advisor. Fidelity does not give tax advice, and nothing we discuss today should be interpreted as tax advice. The information that we're going to be providing is going to be general in nature, and it may not apply to your situation. Everything is personal, as Chris and I have been saying, down to your personal situation. If you have tax questions about your specific situation, talk to your tax advisor.

So Chris, let's kick it off. IRAs is the first topic, traditional versus Roth, and let our viewers know, what are we going to be talking about here with these?

CW: Absolutely. So let's start off with just sort of a high-level comparison of the two different types of IRAs that are out there. Just as a reminder, on the traditional IRA, you have the ability to make pretax contributions, deductible contributions, and the main benefit to that is that you can get a tax reduction and help reduce your taxes today. Once you put the money into the traditional IRA, grows tax deferred, and then when you take the money out, that's when you typically pay the taxes. So with the traditional, the tax benefit to you is up front if you get the tax deduction.

Roth is a little different. The Roth, you make an after-tax contribution, so with that, there's no tax deduction up front, but you still get the tax deferral, just like with the traditional IRA, but then when the money comes out of the Roth, assuming you meet some of the qualifications that we'll talk about, that money can come out tax free, which potentially can be a very big benefits to folks in the future.

CR: So three elements: contributions, tax-deferred growth, as you said, and there's tax benefits specific to each one. So as I look at and think about our viewers, can anyone open either type? And are there restrictions associated with them?

CW: Yeah, so there are some similarities between traditional and Roth, but there's also some important differences, so we'll kind of go through the high points. Number one with respect to can you make a contribution, it depends on if you have earned income, so things like wages have to have that earned income in order to be able to make a contribution. One exception to that is if I have a spouse, so I'm a married couple; one spouse has earned income, the other one doesn't. I can actually use the earned income from one spouse to allow the other spouse to make a spousal IRA contribution.

CR: So if one is not working, they have that ability to do it in that situation, okay.

CW: That's correct. You can basically take some of the earned income from one and give it to the other to make them eligible.

CR: So the one that has a job, you can apply it to the other.

CW: Exactly. With the traditional IRA, we'll talk about in just a second, there are some income limits on whether you can take a deduction or not, but there is no income limitation on being able to make a contribution to a traditional IRA. Versus the Roth IRA, to be able to make a contribution at all up front, you do have to be under the income limitations that are on the slide, whether you're single, or head of household, or married filing jointly, if you go over those limitations, you can't make a contribution to a Roth.

Now just spoiler alert, we'll talk a little bit how you might be able to convert from a traditional IRA to a Roth to sort of get around some of those contribution limits. That's a Roth conversion; we'll talk about that in just a second. Both types of IRAs, you can put up to $6,000 per year into the IRA, plus if you're age 50 or older, by the end of the year, you can put another $1,000 catch-up contribution.

Traditional IRA contributions may be deductible or it may not be deductible. It's deductible if you are under the MAGI or Modified Adjusted Gross Income amounts on the slide. So again, different limitations whether you're single, head of household, married filing jointly. If you go over those income thresholds, you can still put the money in, but it's not deductible. Roth IRA: no tax deduction irrespective of the income that you have.

How do they get taxed when they're distributed? Very different. Traditional IRA, as the money comes out, all your earnings, any pretax contributions are subject to ordinary income tax, and you may also be subject to a 10% penalty if you take the money out before age 59-and-a-half, and you don't meet one of the exceptions to the penalty. The Roth is tax free. If it's a qualified distribution, so you usually have to wait to age 59-and-a-half, have to wait until it's been in there for at least five years, to be able to avoid the 10% penalty in taxes on the Roth IRA. But assuming I meet the qualification, that would be a tax-free distribution from the Roth.

CR: Okay, so there's some income limitations with Roth. There's the contribution deductibility differences between the two, and as you said with distributions, there's key points to keep in mind here. So helpful to know these requirements.

Now if you're eligible for both, how does someone determine which may make sense, or not, for them?

CW: Sure, so there's definitely different factors to consider whether you should contribute to the traditional IRA or the Roth IRA. So for the traditional IRA, if I want to make a tax deduction, and I can benefit from that today, the traditional IRA might make some sense if I meet the income limitations. If I think I might be in a lower tax bracket, so maybe my situation changes; maybe the federal tax law changes, maybe I move to a lower-tax state, if that's the case, the traditional IRA might make some more sense. Also, if I can't fully contribute to the Roth IRA because I'm over those contribution limits, then the traditional IRA might make sense.

However, there's also some things to think about with the Roth IRA. So, if I like the features of the Roth, I like the tax-deferral and the potential tax-free distributions, and my employer doesn't offer a 401(k) or a Roth 401(k), the Roth IRA might be a good alternative. If I think I might be in a higher tax bracket, then potentially giving up a tax deduction today for the opportunity for tax-free distributions, that might be worthwhile to me in retirement. If I can't make the deductible contribution to the traditional IRA, so it's an after-tax contribution to that traditional IRA, well then I might want to just make an after-tax contribution to the Roth because it's the same tax situation for both of those. And also a traditional IRA, traditionally when you get to age 70-and-a-half, the IRS says you need to take out required minimum distributions. That applies to a traditional IRA, but not to a Roth IRA. So if you do not want to be subject to those rules, contributing to the Roth means you will not be subject to the required minimum distributions.

CR: So these are all good reasons for one versus the other, and figuring out what applies to you makes a lot of sense here. I have heard that there are some pitfalls, things to watch out for with regard to IRAs. Can you tee that up for our viewers today?

CW: Sure. So I would say with IRAs there's a combination of opportunities and pitfalls. So some of the opportunities we hit upon, but there's also one other I just wanted to mention, and that is the catch-up contributions, and don't forget if you're 50 or older, you can make the thousand-dollar contribution, the spousal IRA is often overlooked as an opportunity. But the other opportunity with IRAs is it's actually one of the few tax planning ideas that individuals can do after the end of the tax year. Most things need to be done by December 31st. IRA contributions can be made up to April 15th of the next year, so I now have the power of hindsight; I can look at, what was my tax situation, which might be better for me, and I have up 'til April 15th to make that contribution.

The other opportunity is a Roth conversion. So maybe I'm not eligible to contribute to the Roth initially, but maybe I can convert from a traditional to a Roth. So more on that just a second.

CR: Yeah, because that's what you talked about; there's income limitations associated with that, but this is one way, potentially, to get by, or do it a different way.

CW: Yes, so it is an opportunity for—

CR: So we'll touch upon that in a little bit.

CW: Yes. And to your question about pitfalls, there are two pitfalls that people should be aware of with IRAs. Number one, if you have a 401(k) plan, oftentimes if you separate from service and you're age 55 or older, you can take money out of the 401(k) plan without the 10% penalty. You still pay tax, but no 10% penalty. However, if you take a 401(k) plan and roll it over to an IRA, now you lose that age 55 exception; you have to wait until 59-and-a-half before you can avoid the 10% penalty unless you meet one of the other exceptions, so that's one pitfall. The second pitfall is with

the IRAs, you have to remember that you will be subject to those required minimum distributions. So most people aren't aware that they have a 70-and-a-half birthday, but the IRS thinks you do have a 70-and-a-half birthday.

CR: My kids celebrate half-birthdays; I don't know when you get older though, no. (laughter)

CW: Yeah, so I guess, as you get older, they come back into favor again.

CR: But the government takes it into consideration.

CW: Yeah, so it's one of those things that you have to pay attention to, because if you're required to take a distribution and you don't, there's a 50% tax on the amount you should have taken out.

CR: That's steep, yikes.

CW: That is a very steep penalty, so again, one of those things you probably want to mark on your calendar.

CR: It's a major pitfall to be recognizing there. So, you know, to your point, and I'm glad, I jumped into pitfalls, but opportunities is a good way to look at them first, and then those two pitfalls if you need money in that four-year period between 55 and 59-and-a-half, and to your point of required minimum distributions and being aware of those limitations, because no one wants a 50% tax bill upon them, for sure.

So now that we've talked about opportunities and pitfalls, I have heard, I have two kids myself, both in college, and that a Roth potentially can be opened for your kids. To what age, and would it still apply for my kids?

CW: Yeah, so I think the idea of setting up a Roth IRA for children is actually pretty interesting, for a couple different reasons. Number one, normally I can give up to $15,000 per year under the gift tax rules, but here's an opportunity where I could gift each child $6,000, and instead of just giving them the $6,000, if they have earned income, I could give them the $6,000 and maybe say to them, hey, this is a great opportunity to start your retirement savings. Let's sit down at the computer—

CR: Retirement, at that young age? (laughter) Is it $6,000 per year?

CW: So it is $6,000 per calendar year, per child. You don't have to put it into a Roth IRA, but if they have earned income, so an internship, or a summer job, or maybe their first job, so maybe they don't have a lot of extra cash flow to open up the Roth, you can take that $6,000, help them put it into a Roth. Now, if they're under the Roth contribution limits, then you could just put the

money right into the Roth. If they're over those limits, then there is an opportunity to put it into a traditional IRA, and then convert that into a Roth IRA, so again, alluding the Roth conversions that we'll talk about.

CR: I'd like to know those secrets though if they apply for that, but all right, that's another show. (laughter) Okay.

CW: And I think the other point, the Roth for kids, two points, one of which is, at least on paper, it kind of protects them from kids being kids, as opposed to putting the money into their checking account.

CR: Thinking long term.

CW: So this is really kind of your retirement assets, something for the future. And then also with the holiday season upon us here in a couple of months, nothing says "Happy Holidays" like a Roth IRA contribution, so it is an opportunity to start getting your kids set up for a successful retirement plan.

CR: Yes, and having worked in this business, you can't start early enough. So I definitely agree with you there. All right, so we did mention, and alluded to already, the conversion, from a lot of people have traditional IRAs, or may not have met the requirements from an income perspective with a Roth, but there is this conversion opportunity. Can you help our viewers understand what that means, and what a conversion is, and then some of the benefits.

CW: Sure. So with respect to Roth conversions, basically what you're doing is you're taking a traditional account, traditional 401(k), traditional IRA, and you are moving those assets into a Roth account, so maybe into a Roth IRA. So once you do that conversion, all the assets in that account have all the benefits of the Roth that we talked about. The other important point with a Roth conversion is there is no income limitation. So anybody at any income level can do a conversion, so—

CR: Any age, doesn't matter.

CW: Any age can do the conversion. We'll talk about the penalties in just a second. But this is kind of an interesting way to maybe contribute $6,500 in a traditional IRA and then convert it into a Roth so that I can get that money to have the benefits of a Roth account.

CR: So then one of the questions we get quite frequently is, well, is there a tax implication to that?

CW: Yeah, I was going to say, is there a cost to convert? (laughter)

CR: So there is potentially a tax implication here, and that is, if I have an IRA where I made pretax contributions or a 401(k) where I made pretax contributions, and there's earnings on that, the pretax balance plus the earnings will be subject to income tax when I convert it. However, there is no 10% penalty whether I do it after 59-and-a-half, or before age 59-and-a-half, so no 10% penalty on the conversion.

CR: Okay, but it is important for our viewers: you want to go in with your eyes wide open here. And given that there are tax implications, that totally makes sense. Okay.

All right, so now that we know what it is, and that there's tax implications, what else can you share?

CW: Yeah, so I think a couple of points, or maybe points and counterpoints with Roth conversions, and the question we get quite frequently is, should I convert?

CR: Yeah, what makes sense for you?

CW: Yeah, and the answer to that, and almost every other tax question is, it depends. And in this case, it actually depends on a number of different factors, and they all have to be weighed differently depending on your own personal situation. But just to highlight some of the things that people should be thinking about.

CR: Okay, so this is like a tennis match, point, counterpoint. We're going to go back and forth.

CW: Yup, so we'll compare and contrast, and hit most of these and how they come into play. Probably one of the biggest factors, so if I want to do the conversion, and have a tax liability, tends to make more sense that you pay the tax liability with assets outside of the IRA, because if I have to pull money out of the IRA to pay the tax bill, now I have less money to grow tax deferred, so really need to think about, do I have the cashflow to do that? As part of my estate plan, who's going to get that IRA? Is it going to go to charity? Is it going to go to my heirs? If it's going to go to charity, leave them a traditional IRA, because the charity won't pay income tax or estate tax. If I'm going to leave it to my heirs, maybe I convert it to a Roth, because then they're not going to pay income tax on that Roth when they inherit it, so it might be more of a benefit if it's going to heirs to do the conversion.

CR: It's a good reminder to have that spelled out. A lot of people don't necessarily have that in their estate plan, so it's important.

CW: Yeah, checking those IRA beneficiaries to see where it's going to go.

CR: Exactly, for sure. Yes, all right, so two of those counterpoint-point. Next one.

CW: Yeah, so if I'm going to do a conversion, there's going to be a tax hit. So just kind of make up for the tax hit, I need to have a longer-term time horizon. So if I'm going to have that longer-term time horizon, makes sense to convert. Don't have a longer-term investment horizon, may not make as much sense. If I have an IRA, maybe I've set it up recently and I think it's going to grow between now and when I need the money, why not pay the tax today—

CR: Well we all hope. (laughter)

CW: It's going to appreciate. Pay the tax today; that might make more sense. But if we have a market correction, or my investments don't perform well, did I really want to pay taxes on something that's going to go down in value over time? So again, thinking about your investments over time.

If I think my tax rate's going to go up, or maybe stay the same, that tax-free distribution from the Roth makes more sense, so I might want to convert. If I think my tax rate's going to go down, so federal law changes, I move to a lower-tax state, maybe the traditional IRA, staying with that might make more sense.

A couple other points, if I'm normally in a high tax bracket, which today would be about 37%, and I happen to be subject to the alternative minimum tax, which we could spend a whole hour just on that, but we won't. The alternative minimum tax is basically a maximum tax rate of 28%. So that's a relatively low rate for many folks. So if you're going to be in the AMT, maybe you do the conversion—

CR: That can make a big difference.

CW:—versus, if I'm now out of the AMT and at 37% again, maybe it makes less sense. If my IRA has a high cost basis; what do I mean by that? So I made my $6,000 per year contributions, they weren't deductible. I did that for a number of years, and maybe I just have a little bit of earnings on that account. I'm not going to pay a tax on those contributions, because I've already paid tax on that money.

CR: Right, that $6,000 you put in.

CW: Right, so that high cost basis IRA would be a good asset to convert, because there'd be little tax on the conversion, and I get tax-deferred, tax-free growth in the future. Versus a low-cost-basis IRA, I may have a relatively sizable tax bill when I do that conversion.

I guess just a quick note there; Roth conversion is not all-or-nothing. I might be able to convert 10% or 20% or 50%, so I can convert as much—

CR: It's not an all-or-nothing; not a one-size-fits-all.

CW: Exactly. I can fit what makes sense for me from a tax perspective, from a cash flow perspective.

Last point I'll make here is sort of combining different strategies. So if I'm thinking about doing the Roth conversion, big tax bill, potentially. Maybe I think about using that year to make a large charitable contribution, to give me a deduction to help offset that tax bill. So a lot of times, we'll see people combining those two items to help reduce the tax on the conversion.

Now the final point I'll make here, under prior tax law, if you converted an IRA to a Roth IRA, if you paid that tax bill, and now you had a change of mind, you basically got the equivalent of a mulligan, or a do-over, so that you could unwind that conversion and not pay the tax on it. The law has changed so you can't do that anymore, so you just have to be very comfortable with the fact that you've made this conversion and you will have—

CR: Right, it's one-and-done; it's no going back. There's no reverting to your point. I get too many mulligans, by the way. So we talked a lot though about cash flow and the fact of this conversion, you could potentially get hit with a big tax bill. If you were converting 100%, even if you were converting a portion, how would someone be able to calculate, and know, going with their eyes wide open, what would you recommend there?

CW: Yeah, so I think this is definitely one of those areas where it makes sense to crunch the numbers. Again, we looked at a lot of factors. Some of them you can run a calculator on; some of them you can't, necessarily, but at a baseline you do want to sit down and run some numbers, taking a look at some online calculators, maybe talking to your tax advisor or financial planner to see if there's a calculator that they might use, just to kind of put in some information about your age, your time horizon, your rate of return, and then one of the important questions is, "What's your tax rate going to be in the future?" Now, if I had a crystal ball I could probably predict that, but mine's still in the shop, (laughter) never seems to come back from being repaired, and it is very difficult to know what tax rates are going to be in the future. So what we have on the screen, it's just kind of a historical comparison. The light green is the lowest tax bracket each year; the dark green is the highest tax bracket each year. And what you can see since the late '90s, early 2000s, we tend to be in a relatively low tax environment, all things being equal. Now, that's the way the law is set up until the end of 2025, current law, scheduled to sunset. May or may not sunset; we'll have to see. But even depending on what the tax law does, my personal situation might change, putting me in a different tax bracket. This is just federal rules. What if I move from one state to another? My state tax could be higher, could be lower. It depends. So you do need to be giving some thought to what your situation might be when you're taking distributions from the IRA.

CR: Right, there's lots of factors to consider, and you may or may not have all the answers, and I don't have a crystal ball, either. (laughter) I don't think our viewers do. So, to your point, it's just taking all of this into consideration, and reaching out to tax advisors when it makes sense, to really understand your personal situation. So, first topic under, and we've covered it: IRAs. Our

next section is near and dear to my heart. As I mentioned, I do have two kids, and they're both in college. And this one is all about the cost of college, or—and how much it's rising. And it's crazy. How are people paying for that today, Chris?

CW: Yeah, so I think—and we'll certainly talk about college costs, and we'll talk about how to pay for it, and then we'll focus a little more in 529s specifically as a tax-efficient vehicle to help pay for those college costs. But just to kind of put it in perspective, here's some average college costs for four-year private schools, tuition, room and board, some of the other expenses. Going to a public school as an out-of-state student versus an in-state student, and then a two-year school, as well—and, I guess, also having one that's now in college and one about to go to college, I soon realized these are averages. (laughter) Your experience may vary, and could be higher, could be lower.

CR: It depends, as you said. (laughter)

CW: It does. And—

CR: On their choice.

CW: And so I guess the question is, as you look at numbers like this and the costs continuing to increase, is, "How are you going to pay for it?" and you need to be thinking about, "How much am I going to pay out of pocket for this?" So how much is going to come from my income and my savings? Is it a quarter of the cost, half the cost—

CR: Yes.

CW:—75% of the cost? So the good news... Yeah.

CR: It's crazy. I mean, when you look at that just—the chart you just had up, and the difference between that in what your child makes can significantly impact how you're going to pay for it, and these particular sources, and what you're looking at.

CW: Yeah, it really does, so to do your homework to think about what that cost may eventually be will help you determine how much you might ultimately need to pay out of your own savings. So the good news is most folks are not paying for college costs 100% out of their own savings or out of their own income, so here are some statistics that show basically half of the cost usually coming out of personal savings, some from the parents, some from the students, but then roughly a quarter coming from scholarships, and grants and about a quarter coming from student loans.

CR: So I can see we're a testimony to this slide, (laughs) because we're pulling from all three of those ourselves right now with two in college.

CW: Yeah, and I think that's a pretty common situation, that it is a mix of all of these sources to help cover those—

CR: Yeah, it's too expensive not to, you know, have that mix.

CW: Yeah. So the point we're going to talk about here is the family savings piece, since that's about half of it. And there's traditionally, and there still is, many different types of vehicles you can use for college savings. 529 plans we'll focus on primarily, but it is just worth mentioning there are other vehicles out there: the Coverdell Education Savings Accounts, kind of like an education IRA where I can put a couple thousand bucks a year in and use that for college, or even for elementary school or secondary school; savings bonds—the interest isn't taxed if it's used for qualified education expenses; custodial accounts—the UGMAs, the UTMAs—ways to set up accounts outside of the parent's name, in the kid's name, to help save for college, as well, less tax-efficient than they used to be but it is still a vehicle that's available; IRAs—take the money out, use it for qualified education expenses, not subject to the 10% penalty—

CR: Oh, okay.

CW:—and then don't forget I could just set up an account in my own name in a taxable account and then just use that to pay for college savings. So it's not all about 529 plans, but because some of the advantages of 529s we see them more and more popular.

CR: Yeah, I was going to say, because we primarily use 529 but we are supplementing with some of these other vehicles that you said, because 48%, as our previous slide showed, is a lot, so I think that's really helpful to understand all that you have access to.

CW: Yep. So I think 529 plans, and part of the reason why they are so popular nowadays, is for a couple reasons. One reason, primarily, is they're pretty tax-efficient. Not only did the money grow tax deferred, and it may come out tax free if it's used for a qualified education expense: a tuition; room and board if they're in school at least half-time; books; even some computer equipment can qualify.

CR: Okay, great.

CW: There is no federal tax deduction for setting up a 529 plan, but you may get a state tax deduction if you live in a state that allows a deduction. Oftentimes, if you contribute to that state's 529 plan you may be eligible for a state tax deduction, so something to look into if you're eligible for it. Generally mutual funds in these plans, so relatively low fees, and then a number of investment choices. You have sort of your age-based fund. It's kind of like a target date fund, so as my child is getting closer and closer to starting college and in college the mix automatically becomes more conservative over time, less risk taken on the investment portfolio.

CR: Yeah, similar to a target date fund in the retirement space.

CW: Yeah, very similar to a retirement target date fund. Risk-based, so I could pick a portfolio of investments with lower risk, medium risk, or higher risk, depending on my personal risk tolerance. And then there's often other investment options, as well, that I can pick from. So, again, depends on the plan, usually a number of options that are available.

CR: But, to your point, it is a very tax-efficient way to save and invest for college, and it provides a lot of other benefits worth considering, to your point.

CW: Yeah, I think some—we'll mention some benefits here, and a couple of other benefits in just a second, but I do think how it's counted for financial aid is important, if that's something that might be—

CR: It's a common question we get—

CW: Yeah.

CR:—often, how much does it impact, so we'll be getting to that. But yeah, to your point, there are lots of benefits, and can you cover a little bit more of those in detail?

CW: Sure. So I think on 529 plans, some of the main benefits: put the money in, no federal tax deduction, but the money does grow tax deferred, so the interest dividends, capital gains not being reported on my personal tax return. If I use it for those qualified education expenses, there's no federal tax on that amount. The other thing I just mentioned on qualified education expenses is 529s used to be primarily for college—two-year, four-year, vocational school—but now, under the new tax law, you can take out up to $10,000 for either a public or a private elementary school or secondary school—

CR: Ah, okay, so it's not just for colleges and universities; you can apply it for elementary—

CW: Yeah, you can apply it—

CR: Okay.

CW:—for younger years. Now, that's for federal purposes. You do have to check your state tax rules to see if they will give you a tax-free distribution.

CR: So that's a—it depends. You have to—

CW: It depends on the state.

CR: (laughs) Okay.

CW: Correct.

CR: All right.

CW: The other interesting thing about 529 plans, so your situation, my situation, two children, if I set up a 529 for each of them, and I need to take money from one, because child number one's done with school, I now have extra money in the 529 plan and I want to move it to child number two, I can change the beneficiaries at any time, which is a nice benefit to be able to—

CR: Yeah, that's huge.

CW:—move it around. And then, as we mentioned, I may get a state tax deduction when I put the money in, and then also from a state tax perspective, maybe tax free, as well, when I pull money out. So, again, lots of investment flexibility and some great tax benefits to a 529.

CR: Oh, for sure. I'm glad you covered that. Now, I've had some friends, as I mentioned—I did save and invest in a 529; some of them had a prepaid option, as well. From what I understand there's two under the 529 umbrella. Could you explain that to our viewers?

CW: Sure. So the 529 plans, which are also sometimes referred to as qualified tuition programs—they're sort of used entertain—interchangeably—they do come in two flavors. One is the college savings plan, where it kind of works like a 401(k) or an IRA, where I put the money in, I pick my investments, and depending on how it performs that's what's available to pay. But there's also another type of plan called a prepaid tuition plan—it's also a 529 type of plan—which works a little bit differently. So we could just spend a minute sort of comparing and contrasting the two. And when you look at them from a tax perspective, they're pretty much the same, from a tax point of view. It really comes down to their investment objectives, and then also some of the schools that you might be able to use the plans for. So a 529 prepaid tuition plan is kind of like the name implies, I am buying tuition now at today's prices and locking that in for the future. So the main benefit is that the plan is taking the investment risk in that situation, versus the 529 savings plan I'm putting the money in, I'm making the investment choices, and how my investments perform is going to drive how much is available to pay for those qualified education expenses. You could put the same dollar amount into each of those plans, very high contribution amounts you can typically put into the plans—depends plan by plan but usually into the six figures that you can ultimately put into these things. From an investment point of view, the prepaid tuition plan is really for somebody that's more risk-averse, not comfortable taking market risk, whereas the 529 tends to be a little more comfortable taking that risk. Now, you did ask about the effect on financial aid. So you can see here—

CR: I did, yes.

CW:—the 529 plan is only 5.6, roughly, percent of it is counted towards the expected family contribution amount. So from an impact on financial aid, less of an impact than some of the other potential—

CR: Right, at 5.6%, it's on the smaller end. (laughs)

CW: Yeah, so that definitely helps.

CR: Okay.

CW: So I think, yeah, do you pick one? Do you pick the other? One of the other important things to take a look at for the prepaid tuition plans is what schools can you use it at—

CR: Yes.

CW:—because I remember looking at some of these plans way back when, when my kids were younger and starting to think about college. You would look at some of these plans, and it was a little more limited on what schools you were buying the prepaid tuition at, and then what happens if your child doesn't go to one of those schools. So you want to be aware of what those things are, versus a 529 savings plan can pretty much be used at almost every college or university in the United States, maybe some even outside the U.S., as well, so it has a much broader pool of schools potentially available to be able to use that money for qualified education expenses.

CR: Yeah, I'm glad you pointed that out because it is an important factor to be considering, because the limited number of schools that may look for the prepaid or they can apply to—

CW: Yeah.

CR:—may be limiting based on, again, your personal situations and where your kids may want to go. Okay, so a lot to consider in the college space, and in particular with all the vehicles that we talked about and the 529 savings plans. We're going to switch gears now and we're going to cover our third topic, which is the state tax considerations. So many people live in one state, may work in another; they might own real estate in multiple states, and I know we're going to be hitting upon that. And, in particular, can you kick us off with this third section here, Chris?

CW: Sure. So usually when we're talking about taxes, or oftentimes when we're talking about taxes, we're focused on the federal rules, right? Because that applies to everybody across the country, for the most part. But state taxes, little harder to make generalizations because there's 50 different states with all different rules, and people living in all those states, moving across those states. But I do think there are some things that we can make people aware of so that they're being thoughtful about where they live, where they work, what they might need to do when they switch from one state to another, what types of records to keep. So we'll start off by just talking

about state tax rates generally, and we'll talk about why that's become even more important under the new federal tax law. Talk about how a state taxes its residents, so the people that live there. How do they tax their nonresidents? So maybe people that work in that state, maybe people that own real estate in another state. So we need to talk about those rules. Get the question all the time, "If I live in New York, work in New York, and I retire to Florida, can New York still tax me?" It depends. So—

CR: It's a key theme, Chris. (laughter)

CW: It is very key in the world of taxes. So we need to also talk about what types of income are you receiving, because they do receive different tax treatment. So we'll talk about that. What do I need to file state tax returns? So we'll talk a little bit about the documentation you might want to keep, and if there's planning opportunities to be thinking about in the space.

CR: Yeah, because there's lots of implications here, it sounds like, and this is an important topic, because it can really impact your overall situation, so being aware of it, even—

CW: Yeah, I think it's—

CR:—is what I think I'm hearing you say is important.

CW: So I think awareness is very important, but I would also make the argument that taxes are not the main determinant of where people live in retirement. (laughter) It's one factor—

CR: Yes.

CW:—but when I tell people, or historically have told people, that Alaska looks like a great state from a tax perspective, haven't had too many folks that I've worked with that have retired—

CR: Raise their hand and... (laughs)

CW:—yeah, say Alaska's where they want to go.

CR: Yeah, I would say at least if tax is in your sweet spot of making the decision, it's great, because that's where we want them to be is being aware of what that—

CW: Yep.

CR:—what that might mean. Okay.

CW: And so this map of the United States just kind of highlights for you the wide variety of tax rates that we have across the country. So I think a lot of people would hold out California and New York sort of as two of the higher tax jurisdictions, and they are, but there are others: Oregon and Minnesota, Maine, and other folks that are also very high. The states that tend to get a lot of attention are the green states.

CR: Yeah, I'm liking the green color, Chris. (laughter)

CW: Yes. So the no income states, so Florida and Texas are two of those, Nevada, pretty popular with folks on the West Coast, but there are some others that are out there, so don't forget the New Hampshires of the world and South Dakota and Alaska, also zero-tax states. But, as I mentioned, people are really living where they want to live first, and then taxes is really just one of the many, many factors.

CR: Weather and family is up there for me. (laughs)

CW: Yeah, those are usually the main drivers. The other reason this has become so important is it used to be that if I paid a lot of state taxes that potentially I could itemize that as a deduction on my federal tax return, so that federal tax benefit helped offset some of the cost of the high state taxes. The federal rules changed pretty dramatically at the end of 2007, saying that now I can only deduct up to $10,000 of state income tax and state property taxes, and so that was a major limitation for people especially that lived in the red states on the map. So people that might have been on the fence about should I stay, should I move somewhere else, now it's taken a renewed focus because now the state taxes are costing them more—

CR: More.

CW:—without that deduction.

CR: More money to live there. Mm-hmm, okay. All right, so now we're going to talk residents, nonresidents, how you determine which you might fall into based on the state and your situation at hand.

CW: Yes, I think there are two main considerations when it comes to state taxation: am I going to be deemed a resident of the state, or am I a nonresident of the state? The key difference: if I'm a resident I'm taxed on all my income, no matter where it's earned; if I'm a nonresident I'm typically taxed only on that income that's somehow connected to that state. So I worked in the state, sold a property in the state, had rental income in the state, so only taxing me on that state-source income if I'm a nonresident. So are you a resident? There's two different tests, so we'll talk about that in just a second.

CR: All right.

CW: And then the other thing that we will talk about, as well, is what type of income are you receiving. So if I change from being a resident to being a nonresident, can I still get taxed on income after I move out of a state? So we have to look a little bit about the different types of income that I'm receiving. Are you a resident? There's two primary tests. Now, what I should say here, and we said it upfront, that these are general rules, right? There's 50 different states. There's 50 different variations on this theme, but there's a lot of common overlap between them. So one of the things that most states will look at is you're a resident if you're domiciled in our state. What's domicile? It's really a state of mind. It's where do you intend your home to be. And so the way I like to frame it is if you're away on vacation, you're walking down the beach, somebody approaches you and says, "When you're done with your vacation and you're going to go home, where are you going to go to?", the answer to that question is probably where your domicile is.

CR: That's where your domicile is.

CW: So you can have many homes—you can have two homes, three homes—but you can only have one domicile.

CR: Okay. Is another way to look at if that's where my driver's license is from, or where I get my mail sent? Those some of the factors that consider your domicile?

CW: Yeah, so, again, every state has a slightly different test that they look at, but—

CR: Okay, so you have to know your state rules. (laughs)

CW: Need to know the state rules, but there are, again, some common themes. So, to your point, where do I have a driver's license? Where am I registered to vote? If I have more than one home, what's the relative value of those two homes? What's the size of those two homes? Where do I go to church or synagogue? Where are my golf club memberships? Where's my family? In some cases, it's actually, some states, where's the family pet.

CR: Oh, okay. (laughs)

CW: That's one of the factors that they look at as to where your—

CR: How does someone find out for your particular state? Where do they turn to really understand—

CW: So with—

CR:—if they needed to?

CW:—with these state rules, they're usually spelled out on the state Department of Taxation websites, or even in the instructions to the state forms; it'll say "You're a resident if" and then give you some details. But this is one area where I think talking to a tax advisor makes a lot of sense, because it's not just about the rules; it's the application of those rules to your particular facts and circumstances. And there might be a lot of court cases, there might be a lot of regulations that sort of expand upon those rules, so really to talk to a tax advisor to understand what's going to drive if you're domiciled or not.

CR: Sure, okay.

CW: Just a couple of other quick points here. If you are domiciled in a state, usually you're taxed as a resident of that state. Now, if you're domiciled in the state because you have a home and your family's there, might be possible to be treated as a nonresident if you didn't spend any more than 30 days in the state, so maybe you're in the process of moving from one state to the other; you kept a home in another state, so didn't have just the home in the one state. It may very well be possible to not switch your domicile but be taxed, ultimately, as a nonresident.

CR: Okay. Lots to consider here. (laughs)

CW: Yeah, and I think—

CR: All right, yes.

CW: Yeah, so I was going to say, the question we hear from folks quite frequently is, "Well, I've heard that if I have a home in a state, and I don't spend 183 days in that state—"

CR: And 183 is six months?

CW: Six months.

CR: Okay.

CW: So, "I spend less than six months in that state, then I won't be a resident of that state." Well, that's partly true, because you won't be a statutory resident—which we'll talk about in a second—but you might still have your domicile in that state, you might still have a home in that state, and you might have spent more than 30 days.

CR: Yes, okay.

CW: So it's usually one of the two. And the statutory residency, the good news/bad news is it is a black-and-white rule for most states. If I have a permanent place of abode, which is just a fancy way of saying house, apartment, condo—

CR: Condo, okay.

CW:—basically not a hotel room—if I have a permanent place to stay, and I spend more than six months in the state, I'm a resident.

CR: You're a resident.

CW: So, again, depends on the state, but that's the general rule if they have a statutory residency requirement.

CR: Okay, all right. Now, where are we going next with the state tax residents?

CW: Yeah, so if we talked about—

CR: Nonresident?

CW: Yeah, if we talk about resident, now we need to talk about nonresidents, as well. So do I only need to pay state taxes where I live? Maybe, maybe not. So if I do have income which is sourced to another state—so, as I mentioned, I own a rental home in another state, that state wants to tax that rental income. If I sell real estate in another state, probably pay nonresident tax to that state. If I, in my case, live in New York, work in New York, but maybe spend 10% of my time working in another state, that other state might say 10% of that compensation is going to get taxed to our state. So it depends on the state, have to look at their rules around—

CR: Sure, that makes sense. What about different forms of compensation? How does that come into play here?

CW: Yeah, so different forms of compensation, you do have to take a look at, "What did I get paid?"—Was it a salary? Was it a bonus? Was it a multiyear bonus? Was it a stock option?—so I need to look at what was the type of income, what period of time was it earned over, how much time did I spend in the state during that window of time, look at the state rules, and then figure out how much of that compensation would get sourced back to the state. Another common example: I have somebody lived in New York, worked in New York their entire life. They pack up, move to Florida, buy a home in Florida, and then they get some payments to them while they're in Florida. They get a bonus paid out. They exercise a stock option. They start collecting their pension. Question we get is, "Can New York still tax me?" Compensation income, they can still tax you. If it's the rental income, gain on sale of my home, they can still tax me. But there is a federal rule that limits states' ability to tax retirement income: pensions, 401(k)s, IRAs, certain nonqualified pensions, certain deferred compensation plans. And the reason I put this code section on the slide—because I'm not one to put code sections on slides just to put code sections on slide—is because this 4 United States Code Section 114 is something that has tax implications that's not in the Internal Revenue Code; it's in a different section of the law, Federal Limitations on States,

and that has very specific provisions around what states can't tax. So when I mention the IRAs and 401(k)s and things like that, they're spelled out in that provision, so something you want to talk to your tax advisor about to see if you can fall into those specific types of income that can't be taxed by your former state of residence. Last point I'll make here for nonresident states, if I'm working in another state, if I sell a home in another state, how am I going to pay tax to that state? So either withholding—can my company do withholding in multiple states so that I can get the taxes paid in for the time that I work there—or if I have income I might need to make a quarterly estimated payment in that nonresident state to make sure that I'm paying my tax liability throughout the year.

CR: So that totally makes sense. We've covered a lot here with regard to state taxation. Could you leave our viewers with three key takeaways, then, for this particular topic before we wrap it up?

CW: Yeah, so in state residency planning I could answer your question by saying documentation, documentation, documentation, (laughter) and count that as three things, but I won't do that. But I will—

CR: Right, it is the number one thing you need to do.

CW: It is so important that if I'm thinking about changing my residency, if I might be working in multiple states, to keep records currently—calendars; E-ZPass or the electronic toll tags; passports; even cell phone records can show oftentimes where you were when you made a phone call; credit card statements to show where I was when I was having dinner, when I went to a coffee shop, or whatever it might be—holding on to all of that so if the state has a question about your return two, three years down the road you have those records that you can pull out and show them. You—

CR: And with taxes, they're—how long should someone hold onto the stock [invitation?], Chris?

CW: So our general recommendation is, because states and the federal government can look back six years, in many cases, to hold on to at least seven years' worth of records. So you don't have to hold everything back to the 1980s, but probably going back seven years is a good rule of thumb. Also, if you can—again, people's personal situations take priority here, but if I can be thoughtful about setting up my facts to point to on this day this is when I moved from one state to the other—so I changed my driver's license, I changed my church or synagogue affiliation, I had the moving truck show up on this particular day to move my items from one home to the other—that just helps make it very clear that I took active steps to make that switch from one state to the other. The other consideration that we mentioned is that I might be able to not be a resident because I'm a statutory resident—that's the home plus the six months—but if my domicile is still in the state and I own a home in that state, if I spend more than 30 days in that state I could still be a resident. So people are now thinking about should I keep the home in that state, because now I have to be all worried about the domicile rules. Again, family and personal situation comes first, but it's just one more factor to think about.

CR: Yes. Completely be aware of that.

CW: The other question that we get quite frequently is, "I'm not going to be 183 days in any of my homes—so maybe I'm going to spend some months in one, some months in the other, and then I'm going to spend months traveling around the world—where am I a resident?" And so in that instance, what a lot of states will do is they'll take a look at if you had two homes what was the relative time spent in each home. Where did you spend more time? And that points towards where your domicile might be. So you just want to be, again, thoughtful about how much time you're spending in—

CR: Yes. Yeah, you've just—

CW:—multiple homes.

CR:—you've just depicted my retirement philosophy of moving all around and not staying somewhere, but I need to take into consideration my tax considerations with regard to domicile and state.

CW: Yeah.

CR: Okay, so we've covered a lot in this segment. We've wrapped up. We've covered IRAs and retirement, college, and 529s, finally state tax considerations. We're now going to go into our last portion of the show, which is answering the top questions that have come from you, our audience. And, Chris, I'm going to tee up the first question, which is, "Can I leave my IRA to my heirs, and what are the tax consequences associated with that?"

CW: So, yes, you can leave an IRA or a Roth to heirs. One of the benefits that they have is they can usually move that money into an inherited IRA or inherited Roth IRA, so that helps minimize the immediate tax hit, and then allows them to sort of take distributions over time to help continue to defer that tax for some period of time, and help get that tax-deferred growth.

CR: Okay, great. And I am assuming even if you inherit it as an heir you're still under the eligibility, all those types of requirements, and even conversion that we talked about earlier still all apply independent?

CW: Well, yeah, you do have to be a little careful around inherited IRAs, because they do have some different rules from a regular IRA. So one of the things I actually do recommend is the IRS actually has a great publication on IRAs—it's IRS Publication 590—and it's particularly good around explaining the rules on inherited IRAs, what you can do, what you can't do, when you have to take the required minimum distributions, and it really depends on so many different factors. It really makes a lot of sense—that's a good place to start, and then you can be better educated to—

CR: So IRS 590.

CW: Yeah.

CR: And, to your point, the common theme: it depends. (laughs) It's based on your particular situation. So our second question is, "If you are exceeding Roth IRA income limits today, would it make sense to contribute to the Roth IRA after retirement?"

CW: Yeah, so I think one of the key things to be considering about the Roth IRA contributions is will you have earned income in retirement, right? Because we can only make a Roth contribution if we have earned income, but remember that spousal IRA rule: if I'm married, filing a joint tax return, I can take some of my spouse's income and use it as earned income to contribute to my own. So if that's your case, contributing to the Roth after retirement might make some sense. Plus, contributing to that Roth, those assets are not subject to the required minimum distributions, so that might be an advantage to putting money into a Roth after retirement.

CR: Okay. All right, so our next question is regarding 529s. What are the gifting limits for 529 accounts, and is there a good strategy associated with gifting to a 529?

CW: So the annual gift tax exclusion right now is $15,000 per person, per calendar year. So the way that works is I can give $15,000 to one of my children, or to any other person. If I'm married it's $15,000 each, so that's—

CR: So $30,000.

CW:—$30,000 to any individual. Now, with the 529 plan there is actually a special tax rule that says I could give up to five years' worth of gifts in one year, so I could give up to $75,000 myself, $150,000 if I'm giving with a spouse, put that into a 529 plan, treat that as if I made it over five years. If I do that, I do need to file a gift tax return—that's Form 709—so that I can make an election to have it treated as if it was made over five years. So note—

CR: You just rattle off these numbers—709. (laughs)

CW: So it is a very common form, and it is an important election to make. Again, generally, there's no tax when you file that form, but it is something that's important to do if you want to make that election.

CR: So what I'm hearing, though, is $15,000 per person per year, or you can, in a sense, make a lump sum and take five years' worth, which equates to $75,000 per person, or $150,000 if you're in a spousal situation.

CW: Yep. And the main benefit of that is you can get that tax deferral started sooner—

CR: Sooner—

CW:—so I got it into that account—

CR:—than over five years.

CW: Yes.

CR: Okay, perfect. All right, so another question is, "Do you have recommended strategies for converting pretax IRA amounts to Roth IRAs over time, including from time of retirement to 70-and-a-half, when RMDs (or required minimum distributions) start?"

CW: Sure. So I think the important point when thinking about IRAs to Roth IRA conversions is—as we saw before, lots of different points, but one is: it's not all or nothing. So if I'm in a situation where if I did a large conversion, and a lot of that was going to get taxed at the highest bracket, maybe as an alternative I could convert a little bit each year to take advantage of some of the lower tax brackets, and have it taxed at lower brackets. So that's one consideration. The other consideration is if I'm now retired and I'm in a lower tax bracket, that might make some sense to do a conversation, because now my tax rate has gone down.

Also, if I start doing some of those conversions when I'm in retirement, or even before retirement, once I get it into that Roth I'm not subject to those required minimum distributions. So if I'm concerned about the size of these required minimum distributions from my traditional IRA, maybe I start doing some conversions, get it into the Roth, and then not be subject to those RMDs on my Roth account.

CR: Okay. It's really understanding where you are with regard to your tax situation and your tax limits, in a sense, or—limits might not be the right word that I'm looking for—where you are in your current tax situation.

CW: Yeah, I think it's a combination of where am I today, where am I going to be—

CR: In the future.

CW:—in retirement, and then, somewhere in between, what's my tax situation going to look like this year, next year, the year after that? Because I can probably have a little more certainty of what tax rates might be over the next couple of years, because that'll help answer the question should I do it all this year or maybe spread it out over a couple years.

CR: Or spread it out over a period of time, okay. So the next question is, "Do 529 accounts for dependents count as an asset when applying for financial aid?" And I know we touched on this with the five, little over 5%, but can you elaborate for our viewers on that one?

CW: Yeah, so I think that is one of the key attributes of 529 plans is because they do have such little impact on financial aid, versus some other investment accounts, other types of accounts could have a much bigger factor in impacting financial aid. So, as we mentioned, the 529s do get factored into the expected family contribution, but only 5.6% of the assets, so relatively low in comparison to some other types of vehicles, just adding to one more of the positive aspects of the 529s.

CR: (laughs) So, Chris, we have covered an awful lot today, a wealth of information, so thank you for joining us. And thank you to all of you out there for joining us on today's webcast. We hope that you learned a lot about these topics, and things to consider before year-end. Remember, if you have additional tax questions please consult your tax advisor. If you have retirement or investing questions, please give us a call right here at Fidelity. And also we'd love to hear your feedback. Please take a moment to complete the survey so that we can improve your future experience. Thanks so much. Until next time. Bye.

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