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Working-Age Future Retirees Need to Understand MAGI

What goes into MAGI, and stays out of MAGI, matters. A lot.

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Your working-age clients need to understand something important: Their post-retirement modified adjusted gross income (MAGI) could affect how much of their retirement income they can keep.

Many of your clients now depend heavily on 401(k) plans and traditional individual retirement accounts (IRAs) to save for retirement.

Thanks to mainstream media and a fortune spent on marketing by employers and financial institutions, the 401(k) plan and the IRA have become synonymous with retirement planning. Congress ramped up the message via the Pension Protection Act of 2006, which gives employers incentives to auto-enroll employees into 401(k) plans.

The 401(k) plan program currently lets an employee to defer income up to $19,000 in income per year, and it lets employees over age 50 add an extra catch-up contribution of $6,000.

The traditional IRA offers access to a pre-tax contribution of up to $6,000 per year, plus an extra $1,000 for those over age 50.

So why do so many people use 401(k) plans and IRAs?

The most popular reason is that the contributions are pre-tax, meaning that the contributions will lower your clients' taxable income for the year. Accountants by and large love this trait, as it can generate a larger tax refund.

Employer-sponsored plans like the 401(k) may provide a company match, which can be a very valuable perk. Employer-sponsored retirement plans are also accessible and user-friendly. The contributions never even touch the clients' pockets; employers kindly deduct the contributions from your clients' paychecks.

However, what is often described as "tax savings" is not actually savings, but, rather, a compounding tax postponement — to an undefined tax rate that could hit 40 (or many more) years in the future. Some of the cash your 35-year-old client is putting in a 401(k) plan today, in 2019, could be producing taxable income for that client in 2084.

In addition, funds within these accounts generally cannot be accessed without penalty before age 59.5, unless the client uses select hardship provisions or loans. Furthermore, distributions from such plans can create a "tax torpedo": Distributions may not only push up a client's tax bracket, but also:

- Lead the client's Social Security income to be taxed at a higher rate.
- Cause the client's Medicare premiums to be increased.
- Increase the odds that **children's applications for college financial aid will be denied**.
- Expose high-net-worth clients to the risk of having to pay the 3.8% Affordable Care Act Medicare surtax.

Distributions from traditional IRAs and the 401(k) plans can cause all of these problems by increasing the client's MAGI.

Some income sources have generally been excluded from MAGI calculations:

- Roth IRA distributions.
- Roth 401(k) account distributions.
- Health savings account distributions spent on qualified medical expenses.
- Withdrawals from cash-value life insurance policies, if the policies are not seen as being **modified endowment contracts (MECs)**.
- Loans from non-MEC, cash-value life insurance policies.
- Tax-free withdrawals from non-qualified annuities.
- Proceeds from reverse mortgages.

Clients who are working now should recognize the unexpected tax pain many retirees are facing. They should certainly talk to their professional tax advisors. They should give serious thought to 401(k) plan and traditional IRA alternatives that offer the potential for tax-free distributions, greater liquidity and MAGI exemptions.

Traditional IRAs and 401(k) plans may continue to play an important role in your clients' retirement planning arrangements, but your clients should understand the deeper meaning of diversification.

Certainly, clients should diversify their investment portfolios, with a wide range of stocks and bonds.

Clients should also think about diversification with regard to the types of vehicles they use to prepare for retirement income needs, to provide greater flexibility for a time when flexibility may be needed the most.