

Three ways to offset income from a Roth conversion

With the threat of higher taxes in the future, Roth conversions have emerged as a hedge to this risk by providing tax-free income in retirement. The downside is that typically a conversion leads to a higher tax bill today. However, there may be planning opportunities or circumstances to mitigate taxes associated with a Roth conversion

1. Make the most of a business-related loss

Certain pass-through business owners (sole proprietors, LLC members, and S-corp business owners) may be able to apply tax losses from business operations to offset ordinary income on their personal tax returns, including income from a Roth IRA conversion. A net operating loss (NOL) may occur during a tax year when business deductions exceed income, resulting in negative income. While business owners would prefer to avoid losses, sometimes realizing a business loss is inevitable given economic or personal circumstances. Under current tax rules, business owners are forced to carry forward these losses on tax returns.* Business owners may be able to use a loss to offset income generated from a Roth conversion, which may provide efficient tax planning today while creating a source of tax-free retirement income in the future.

For more information on NOLs, consult IRS Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.

2. Significant medical expenses

Under current rules, unreimbursed medical expenses can be deducted from income if total medical expenses exceed 7.5% of adjusted gross income (AGI). For example, consider a taxpayer with AGI equal to \$100,000 and unreimbursed medical expenses totaling \$10,000. For that tax year, a deduction for \$2,500 would be available. Only the amount that exceeds \$7,500 (7.5% of AGI) may be deducted, in this example. While this may be a high threshold for many taxpayers, older individuals with significant medical and health-related expenses and lower income levels may be able to realize a large deduction for unreimbursed medical expenses.

Consider unreimbursed long-term care expenses. If the individual is in a nursing home primarily for medical care, then the entire nursing home cost (including meals and lodging) is generally deductible as a medical expense. If the individual is in a facility primarily for nonmedical reasons, then only the cost of the actual medical care is deductible as a medical expense, and not the cost of meals and lodging. Significant medical expenses may help offset income from a Roth IRA conversion.

Consider this example:

- Claire is an 85-year-old woman residing in a skilled nursing home facility with out-of-pocket medical expenses totaling \$120,000 a year. She is paying for nursing home care from her savings and income she receives from required IRA distributions, Social Security, and other sources
- Since she resides in the nursing home primarily for medical care, costs including lodging and meals (in excess of 7.5% of AGI) are deductible on her tax return

- Her annual AGI is \$60,000
- She has an IRA valued at \$500,000 consisting entirely of pretax funds
- Given her medical expenses, she could convert roughly \$50,000 a year to a Roth IRA without owing any taxes due to her high medical expenses
- Depending on her circumstances, Claire could leave the Roth IRA to heirs as a tax-efficient wealth transfer

For more information on deducting medical expenses, consult IRS Publication 502, Medical and Dental Expenses.

3. Charitable contributions

While the current tax code does not allow much opportunity for itemizing deductions, donating to charities is one of the few deductions available to help individuals manage their tax bill. Those considering substantial gifts in a particular year may have a large deduction available to offset ordinary income. However, there are limits on claiming a charitable deduction in a single tax year (maximum of 60% of modified adjusted gross income or lower depending on the nature of the property donated). Adding income for that tax year may help taxpayers avoid having to carry forward a portion of the charitable deduction to the next tax year. It may make sense to convert traditional IRA assets to a Roth IRA during a year when large charitable gifts are made.

For more information on deducting charitable contributions, consult IRS Publication 526, Charitable Contributions.

** The Tax Cuts and Jobs Act (TCJA) introduced changes to the tax treatment of net operating losses (NOLs). Since 2018, taxpayers are no longer able to carry back NOLs, but instead may carry forward NOLs for an unlimited number of years. Taxpayers are allowed to deduct NOLs only up to 80% of taxable income in that year, and additional limits may apply to excess business losses. Consult with a qualified tax professional for more information on NOLs.*

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