The Seven Cases to do a Roth Conversion

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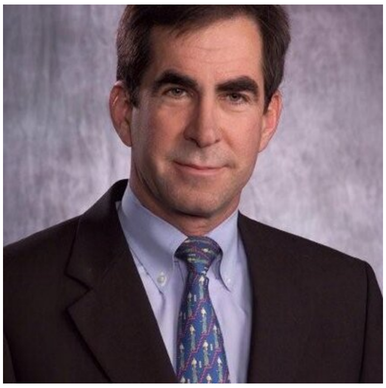

Should your clients convert some of their traditional tax-deferred money (e.g. IRA or 401K) to an after-tax Roth account? Though I'm not related to the late, eponymous Senator William Roth, I spend a significant amount of time with my clients looking at this issue. There are some myths that are just plain wrong. Here is how to think about and frame the conversation with your clients.

I'll conclude with the seven situations to consider for each client when advising on this issue.

Warning: I'll start simple, but get to more complex situations – nothing about taxes is ever simple.

Roth versus traditional IRAs

The difference between a traditional and a Roth is as follows:

- Traditional – get a tax deduction when you contribute but pay taxes when you take it out.
- Roth – get no tax-deduction when contributed but it grows tax-free. You owe no additional taxes upon withdrawal.

It's a decision of paying taxes now or later. And, of course, my analysis is based on current tax law and rates.

The three-bucket approach for tax-diversification

I'm not talking about three buckets of money for spend down, such as a "safe" bucket of cash to live on if stocks tank. I'm referring to three buckets of tax-wrappers to lower the risk of tax-law changes. These three buckets and their advantages are:

- Taxable money. Capital gains taxes are typically lower than ordinary income and there is a step-up basis upon death.
- Tax-deferred money. You get a tax-deduction immediately.
- Tax-free Roth money. It grows tax-free and no RMD must be taken from this pot of money.

Let's face it; none of us knows future tax law changes. Sure, I think tax rates will go up because of our huge debt and deficit (I'm not a believer in modern monetary theory), but logic doesn't usually prevail when it comes to politics. I don't know future ordinary income or capital gains tax rates, the future of the step-up basis upon death or even future estate tax exemptions. And all of those play a role in whether to contribute or do Roth conversions.

Because I know I don't know the future, when a client asks whether they should save in taxable, tax-deferred, or tax-free, my answer is, "yes – all three."

The math behind the contribution

I've heard it said that the Roth conversion makes sense if you can leave in that account for more than a decade before tapping into the assets.

I couldn't disagree more.

We all learned something in elementary school called the "commutative" property of multiplication: Changing the order of the numbers we are multiplying does not change the product.

The simple translation is that if the client's marginal tax rate today is the same as in the future, the outcome is the same. To illustrate, let's say the client is in the 30% marginal tax rate today and our best guess is it will be the same in retirement, when the money is needed. Let's look at both a five- and 30-year period before the money is needed and use a$10,000.00

with a 7% annual growth rate example. Here is the math between contributing to a traditional versus Roth account:

Five-year

Traditional: ($10,000 x (1.07)^**5**) x (1-.3) = $9,817.86

Roth: ($10,000*(1-.3) x (1.07)^**5**) = $9,817.86

30-year

Traditional: ($10,000 x (1.07)^**30**) x (1-.3) = $53,285.79

Roth: ($10,000*(1-.3) x (1.07)^**30**) = $53,285.79

The math between the traditional versus the Roth is merely making a few changes in the order of the multiplication so the answer is the same. The client would be indifferent between a traditional or a Roth account.

If one's marginal tax rate is lower upon retirement when the funds are withdrawn, the traditional is superior. If higher, the Roth wins out. But even if tax rates go up, it doesn't necessary translate into a higher marginal tax rate for your client since they may have little or no earned income in retirement.

The two ways the Roth contribution (or conversion) will backfire are lower marginal rates upon retirement or a major tax overhaul, such as ditching the income tax and changing to a system of a consumption tax (like the Fair Tax Act) that much of the rest of the world uses. Mike Piper, CPA and author of the Oblivious Investor blog, points out that a conversion could push your client's modified adjusted gross income (MAGI) to result in paying the 3.8% investment income tax, which is an argument not to convert. On the other hand, many states don't tax parts of IRA withdrawals, including conversions to Roth's. In Colorado (my home state), each person can recognize $20,000 annually state-tax-exempt between the ages of 55-64 and $24,000 annually if over age 64.

The first complexity – conversion and pay the taxes from a taxable account

Now let's look at the same example (using five years). but assume it's a conversion and the taxes are paid from a taxable account rather than the IRA. For simplification, let's assume it's invested in stocks with a 7% annual return (2% dividends and a 5% capital gains) and a 20% (state and federal) dividend and capital gains tax

Pay taxes from IRA: ($10,000 x (1.07)^**5**) x (1-.3) = $9,817.86 +$3,958.58.44 = $13,776.30

Pay taxes from taxable account: (10,000 x (1.07)^5 = $14,025.52

If one pays taxes from their IRA instead of their taxable account, they will have an additional $3,000 in their taxable account. After paying the 20% dividend tax each year and the 20% long-term capital gains tax at the end of five years, it grows to $3,958.44. Add the Roth value of $9,817.86 and it totals $13,776.30. But converting and paying the taxes from the taxable account doesn't leave that after-tax $3,000 to grow outside of the Roth. Having it in the Roth allows for an extra $249.22 of money to live on after only five years. This extra return comes mainly from taxes avoided by having the $3,000 in the Roth instead of the taxable account. The difference grows over time; at 20 years there is an extra $2,015 if taxes are paid from the taxable account ($38,697 vs. $36,682 or an extra 5.5%).

To understand why this happens, remember that the $10,000 in the traditional is really a partnership between the client and the state and federal governments. Using the 30% tax rate example (ordinary income), $7,000 is the client's share of this tax-advantaged account. If the client pays $3,000 now from their taxable account to convert, they have effectively increased their tax-advantaged portion of the portfolio from $7K to $10K by buying the government's share out with non-tax advantaged money. Now the difference would be less if capital gains taxes have to be paid to raise the $3,000 in the taxable account to pay the taxes.

It is preferable to pay the tax on a Roth conversion from a separate taxable account rather than from the IRA. This is true even if one assumes that a capital gains tax must be paid on the sale of securities from the taxable account that is used to pay those taxes.

The second complexity – Some of the tax-deferred accounts were funded with after-tax money.

This is easier to analyze. Some clients make after tax contributions to their IRAs. While I tell them to stop, it does strengthen the argument to convert. Let's use the same $10,000 conversion example for five years but assume $6,000 came from after-tax dollars. If one converts, they have to pay taxes only on the $4,000 pre-tax amount to get all $10,000 after taxes. If left in the traditional IRA, gains on the entire $10,000 are taxed as ordinary income when withdrawn. This decision to convert is close to a no-brainer – just do it!

Furthermore, if one converts all of their IRA to a Roth, they also have the option of making "backdoor" Roth conversions each year to get more into the tax-free pot of money. Remember, however, that the aggregation and pro-rata rules apply. This means the IRS considers your client to have only one traditional IRA no matter how many accounts they may have. So, in the example above, if the client had a second IRA with $90,000 and all pre-tax dollars, the IRS considers the client has one $100,000 IRA with $6,000 after-tax so 94% of that conversion would be taxable.

But having any after-tax contributions in a traditional retirement account strengthens the argument for a Roth conversion.

The third complexity – estate planning

The estate tax exemption for a couple is over $23 million. But some of my clients have more than this and it's quite possible that the exemption amount will be drastically lowered in the future. Amounts over the exemption are taxed at 40% federal plus possible state taxes. Also, under the Secure Act, a traditional tax-deferred account is even less attractive, as the heirs likely only have 10 years to withdraw the funds. If one has a taxable estate or is concerned about the size of the traditional accounts, conversions can help.

Let's say the client has a taxable estate and a large $4 million traditional IRA. If they convert $1 million, they might pay 40% (state and federal) in taxes or $400,000. This lowers the taxable estate by $400,000 and converts the $1 million into a far more tax-efficient Roth. The heirs will likely have to take it out – over a 10-year period, but they can leave it in that inherited Roth, growing tax free, until the last day of that 10-year period.

Conclusion

In helping a client decide to do partial or full conversions, I consider the following and lean toward converting to a Roth based on an affirmative answer to the following questions:

1. Is the Roth pot of money small compared to the taxable and tax-deferred pots?
2. Is the current marginal tax-bracket low? This could be the case if the client retired before taking Social Security or RMDs, or if they are starting a pass-through business (LLC or Sub-S) with very little income or even losses.
3. Will the client have high income in retirement, such as pension income?
4. Will the RMDs be burdensome if the client doesn't convert some money to the Roth?
5. Does the client have any after-tax money in their tax-deferred accounts and, if all IRAs are converted, will that allow for future backdoor Roth contributions?
6. Will the client benefit from a possible state income tax-exemption for amounts converted?
7. Are there some estate planning benefits from conversions?

While answering "yes" in any of those cases favors a Roth conversion, this must be considered in the context of the dominant reason *not* to convert: A traditional IRA is better if the client's marginal income tax rate will be lower than at the time funds are withdrawn than it is at the time of conversion.

But there are many tax traps. Make sure you are working with a tax expert on conversions. For example, Mike Piper points out that if the client uses her traditional account to pay the taxes and is under age 59.5, a 10% penalty on the amount withdrawn to pay taxes may apply. Another trap is that the income from a conversion may cause the client to be in a higher IRMAA Medicare premium situation. Piper also notes generating $1 too much in income could cost $1,000 per person. Further, income from a conversion may reduce or eliminate other opportunities, such as recognizing long-term capital gains at a zero federal tax rate. Many other tax traps exist, so work with the client's tax-professional. Always phrase your argument using the term, "under current tax law." I use that phrase early and often.

If done right and under the right circumstances, Roths are a great tax-diversifier as part of your client's tax strategies.

Allan Roth is the founder of Wealth Logic, LLC, a Colorado-based fee-only registered investment advisor. He has been working in the investment world with 25 years of corporate finance. Allan has served as corporate finance officer of two multi-billion dollar companies, and consulted with many others while at McKinsey & Company.