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Using Roth Conversions to Preserve Your Retirement Assets

An Underappreciated Strategy to Lower your Tax Burden

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Saving money and generating strong portfolio returns are the cornerstones of meeting your long-term financial goals. However, minimizing the tax drag on a portfolio can have an equally pronounced effect over time. For early retirees, a Roth IRA conversion strategy is an often overlooked, yet highly effective, strategy for shielding retirement funds from a high future tax burden.

This white paper:
- **Explains the Roth IRA conversion strategy,**
- **Demonstrates why early retirees may be in the "sweet spot" for utilizing this strategy, and**
- **Quantifies this strategy's potential for tax savings over time.**

What is a Roth Conversion?

A Roth conversion is an elective event that involves moving funds (converting) from a tax-deferred retirement account including IRAs, 401(k)s, 403(b)s and 457 plans to a Roth IRA account. Ordinary income tax must be paid on the converted funds in the year of the conversion. Once inside the Roth IRA, the funds will grow tax-exempt until withdrawn (subject to some limitations[1]).

The Early Retirement "Sweet Spot"

While Roth conversions may be done at any time, it is advantageous to do so in low-income years. In doing so, the income generated from the conversion will be subjected to lower tax rates, keeping in mind that the Roth conversion itself may put a taxpayer in a higher tax bracket. With a steep drop-off in income, newly retired individuals in their 50's and 60's may be prime candidates for Roth conversion opportunities before their social security benefits and mandatory retirement distributions (RMDs) kick in. Figure 1 illustrates this Roth conversion "sweet spot" that may occur for early retirees.

Required Minimum Distributions (RMDs) and Social Security

Retirees face two federal mandates that when taken together increase taxable income and curtail income and tax planning flexibility upon turning 70:

- Social Security - At age 70, you will start drawing Social Security benefits if you have not already done so.

For high-income retirees, 85% of the amount received from Social Security will be taxable as ordinary income. This has the effect of filling a sizable chunk of the lower income tax brackets, subjecting additional income to higher tax rates than before Social Security benefits began.

- RMDs - In the year you turn 70-½[2], you will start taking annual Required Minimum Distributions (RMDs) from your pre-tax 401(k), 403(b), 457, and IRA accounts or be subject to a 50% penalty of the amount of the RMD.

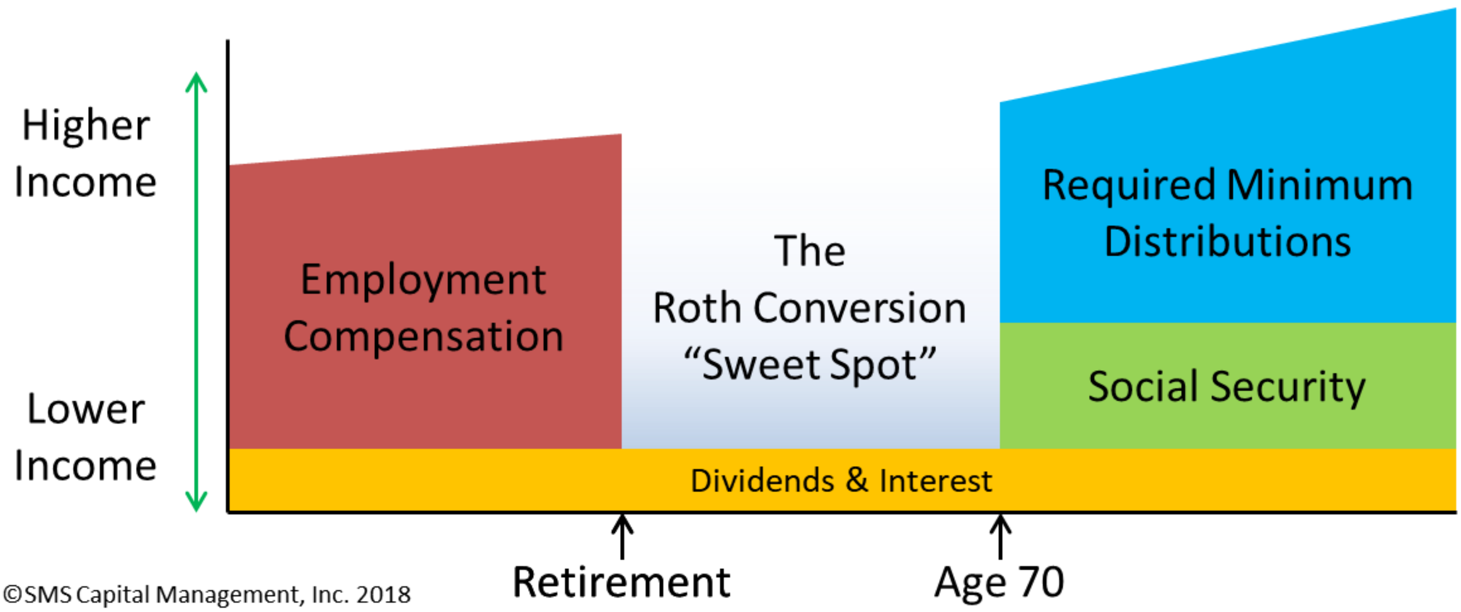
1 If you are under 59-1/2, conversion amounts must remain in the account for five years or the withdrawal may be subject to a 10% penalty. Regardless of age, the Roth account must be open for at least five years before any earnings are withdrawn or these earnings may be subject to income tax.

2 Or by April 1 of the year after turning 70-1/2. However, delaying the first RMD will require taking two RMDs in the following year.

RMDs are mandatory withdrawals of pre-tax retirement funds that are subject to ordinary income tax. RMDs start out at less than 4% of the account balance per year, but balloon to nearly 12% of the account balance at age 95. The continued compound growth of assets along with larger and larger RMDs can quickly accelerate to significant sums of money which is subjected to the prevailing tax rate at the time of withdrawal.

For retirees that saved for most of their careers through an employer-sponsored 401(k) or 403(b) plan, these required withdrawals can grow to well into six figures per year. In such a case, the combination of Social Security and RMDs can push a retiree's income into the higher income tax brackets, irrespective of spending.

Figure 1. The Roth Conversion "Sweet Spot"



The Red Zone

We refer to the highest marginal income tax brackets (e.g. 32%, 35% and 37%) as "The Red Zone." Finding strategies to avoid paying taxes at these high rates is highly desirable; thereby preserving retirees' wealth for living expenses and legacy giving.

For example, consider a hypothetical married couple, both retiring at age 62, with $3,000,000 in tax-deferred accounts. In this case, the couple's assets will likely grow to over $4.4 million by time they both reach age 70 assuming an annual growth rate of 5%. We also assume the couple has $40,000 per year in other income from their taxable investments. As shown in Figure 2, in the year they turn 70-1/2, they will have over $160,000 in RMDs and will also start receiving the maximum Social Security benefit. Moreover, by the time they reach 80, the combination of RMDs (roughly $250,000) and Social Security payments (about $62,000) will push the couple's taxable income into the Red Zone with a total of about $317,000 in taxable income. Furthermore, their taxable income will continue to increase to over $400,000 in their 90s resulting in significant future income tax obligations.

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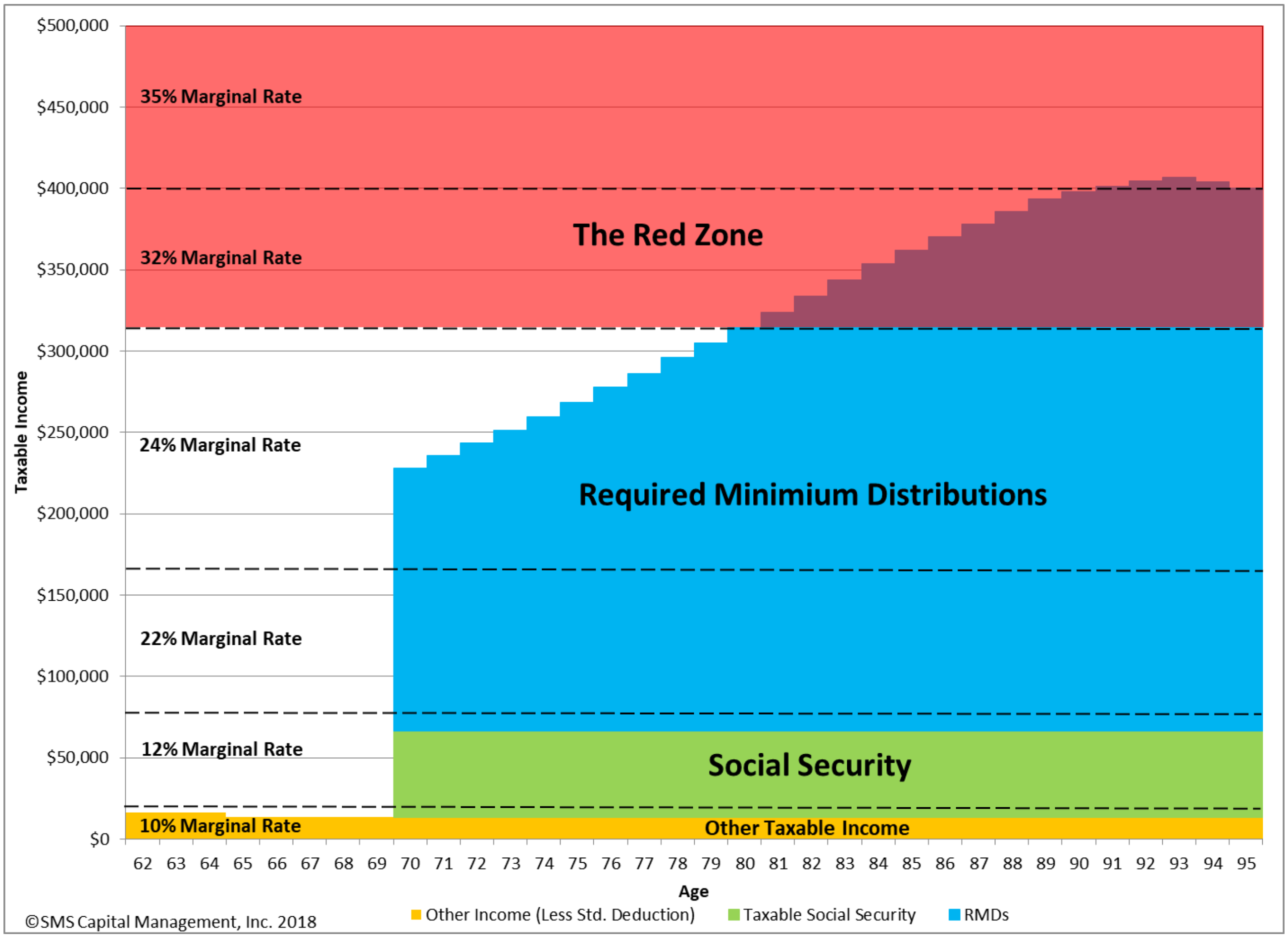
Figure 2. Taxable Retirement Income without Roth Conversions



Note: The example shown above assumes 5% growth of tax-deferred assets with the couple taking their standard deductions. We assume tax rates are static and do not revert to previous levels after 2026. This example assumes this couple has other assets to fund living expenses and taxes in the years before they turn age 70 and only RMDs are taken from qualified accounts.

The Opportunity of the Early Years of Retirement

To lower their tax burden, our hypothetical couple should consider taking advantage of their lower marginal tax rates in the pre-RMD years by converting tax-deferred assets into tax-free Roth IRA assets.

Again, Roth conversions are taxable in the year of the conversion. Furthermore, conversions can be done on a partial basis. Once the money is in the Roth account, it can grow and be withdrawn tax-free[3]. The goal of the Roth conversion strategy is to pay a lower amount of taxes over time by converting pre-tax retirement funds at lower tax rates now to avoid paying tax at higher rates in the future.

3 The Roth account must be open for at least five years before any earnings are withdrawn or these earnings may be subject to income tax.

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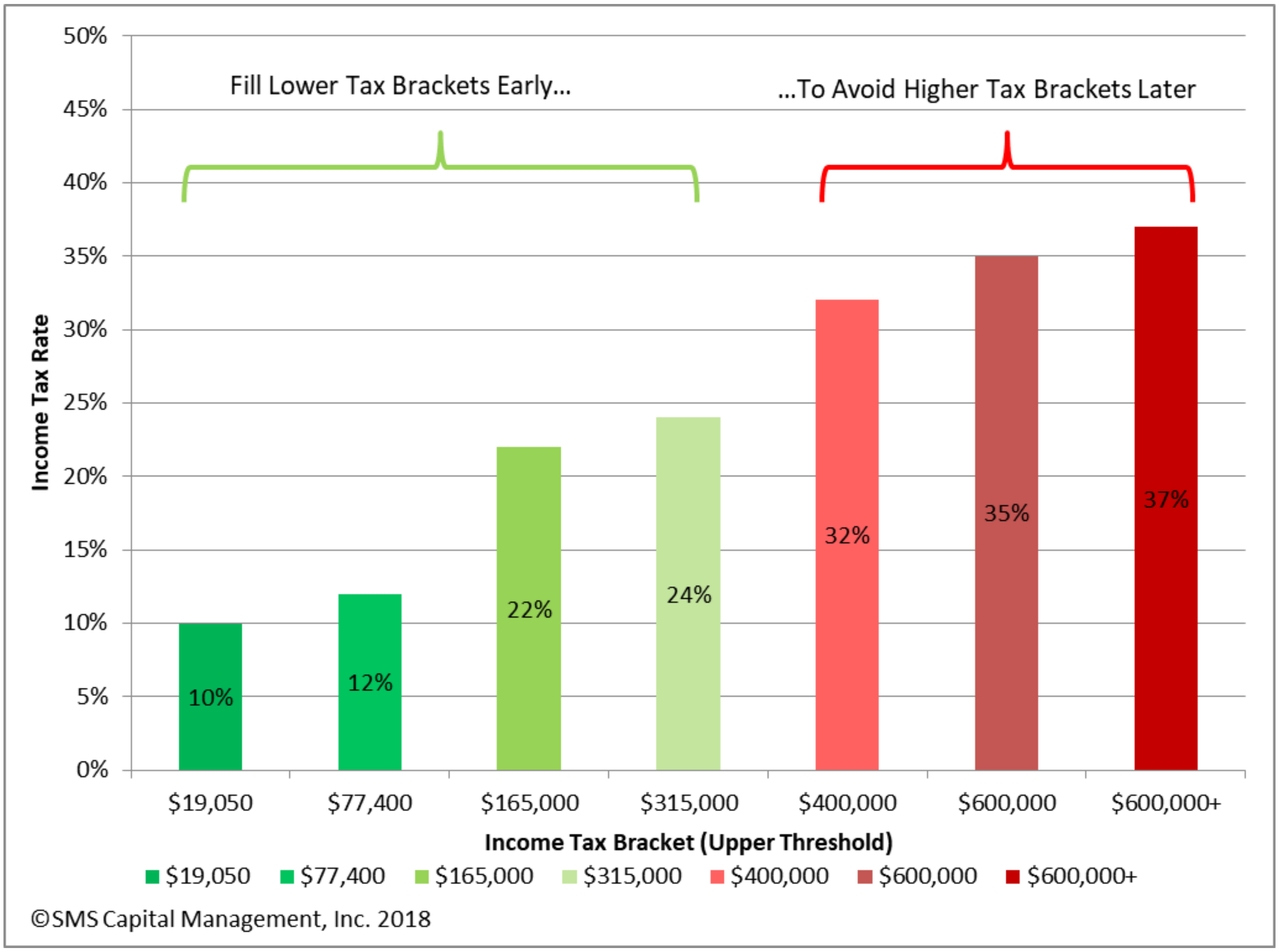
Figure 3. Income Tax Brackets (Married Filing Jointly)



As shown above in Figure 3, systematically converting tax deferred assets at lower tax rates over many years can be a very powerful exercise in lowering the overall income tax impact of future RMDs. By converting tax-deferred funds early at lower rates, you whittle away at the large tax-deferred account balances that drive RMDs and move those funds to tax-free Roth accounts that can continue to grow tax-free over time.

As shown in Figure 4, by performing eight years of systematic partial Roth conversions up to the top of the 22% tax bracket (starting at age 62 and continuing through age 69) the couple converts a total of $1,205,000 from Traditional IRA to Roth IRA assets at an average tax rate of 17.8%. By performing these conversions, our hypothetical couple avoids paying tax in the Red Zone altogether. Their first year RMDs at age 70 are reduced from about $160,000 to $107,000 and future RMDs do not exceed $225,000.

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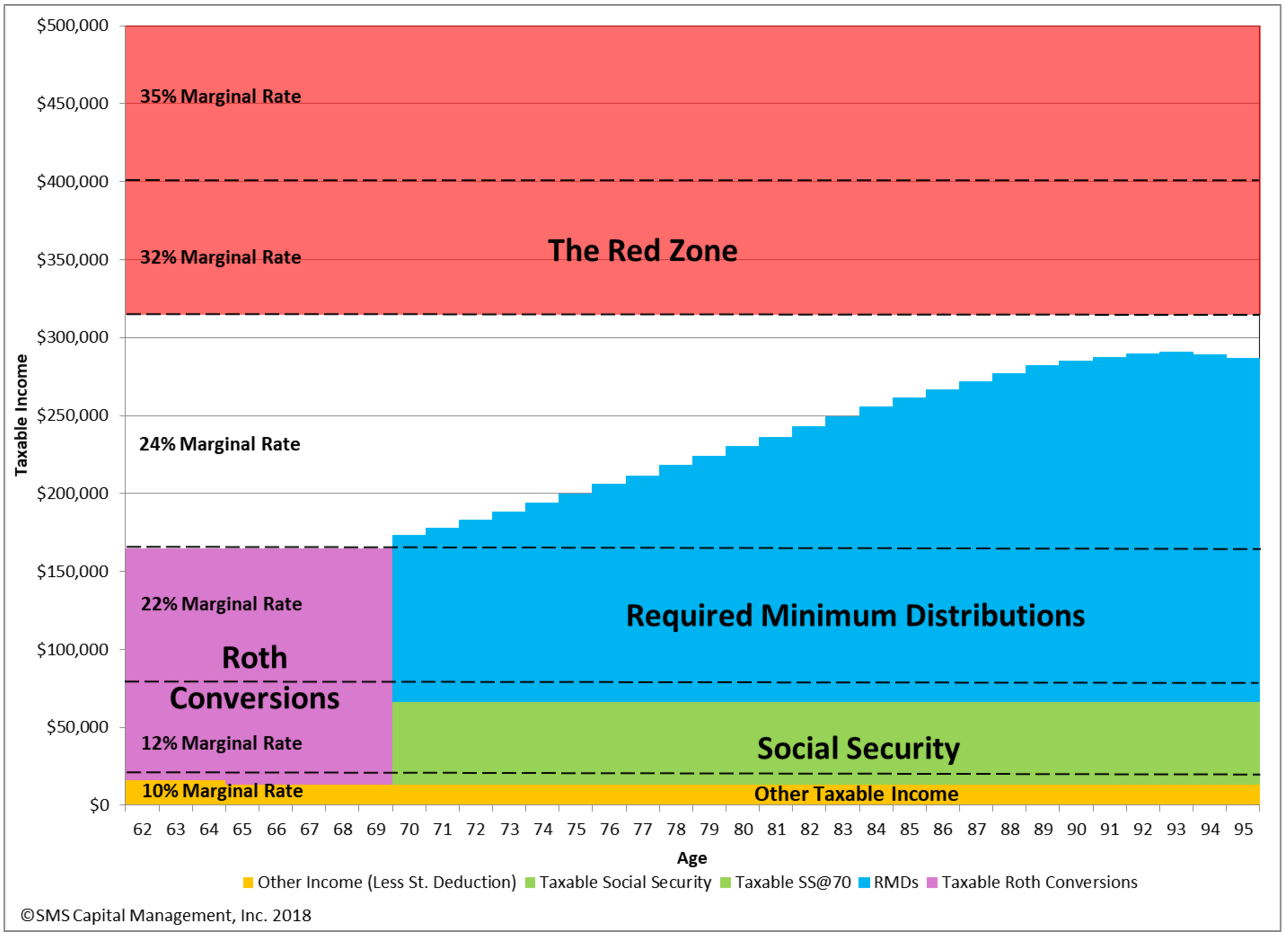
Figure 4. Taxable Retirement Income with Early Roth Conversions



The couple's overall estimated tax savings exceeds $142,000 based on the lower tax rates applied to the Roth conversions compared to their marginal tax rates during the RMD period (see Appendix A). By the time the couple turns 70, the Roth conversions will have grown to about $1.5 million in tax-free assets. This substantial tax savings and resulting tax-free asset base will help ensure the couple has enough funds to meet their long-term retirement objectives. In addition, the Roth account will allow the converted funds to grow and compound over the course of their retirement without further taxation.

Conclusion

The evaluation and implementation of Roth conversions can be somewhat complex and costly if not done properly. Since each household's income situation can be fluid, annual conversions should be evaluated near the end of each year once income is more certain. Moreover, there are many other factors (i.e. tax rates, income levels, etc.) that should be considered when determining if a Roth conversion makes sense. Therefore, Roth conversions should be done with careful planning under the guidance of financial and tax professionals. When implemented properly, this strategy can provide substantial savings that can help retirees comfortably meet their objectives.

If you are interested in exploring whether Roth conversions could be advantageous for your household, SMS can work with you to create a tailored retirement plan that may encompass Roth conversions as well as other effective tax optimization strategies.

Appendix A: Hypothetical Case Study: Estimated Tax Savings with Roth Conversions

Estimated Taxes on Roth Conversions			
Age	Roth Conversion	Est. Taxes Paid on Conversion	Blended Tax Rate
62	$149,000	$26,579	17.84%
63	$149,000	$26,579	17.84%
64	$149,000	$26,579	17.84%
65	$151,600	$26,839	17.70%
66	$151,600	$26,839	17.70%
67	$151,600	$26,839	17.70%
68	$151,600	$26,839	17.70%
69	$151,600	$26,839	17.70%
Total	**$1,205,000**	**$213,932**	**17.75%**

Notes: Assumes $40,000 in outside income and the couple takes the standard deduction each year. Tax brackets are static 2018 brackets and rates. The standard deduction increases from $24,000 to $26,600 in the year the couple turns 65.

Estimated Tax Savings on Roth Conversions	
Estimated Average Marginal Tax Rate in Retirement without Roth Conversions	29.62%*
Blended Tax Rate on Roth Conversions	17.75%
Difference between Average Marginal Rate and Roth Conversion Rate	11.86%
Total Roth Conversion Amount	$1,205,000
Estimated Tax Savings	$142,933

Notes: This estimate assumes that the total Roth conversion amount would otherwise be distributed as RMDs during the couple's lifetime at their average marginal tax rate from age 70 to 95. This estimate does not consider the time value of money or the effect of compounding growth on the magnitude of the RMDs.

*The average marginal tax rate in retirement is the average of the marginal tax rate over the 26 years in which RMDs are due.
As shown in Figure 3, there are 10 years at 24%, 10 years at 32%, and 6 years at 35%, yielding an average rate of 29.62%.

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