Track 1: Retirees and Near-Retirees

Roth Conversion Deep Dive

1:00 - 1:50 pm CDT

CURRENT SESSION

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Roth Conversions: A Deep Dive

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What is a Roth conversion?

- Moving money from tax-deferred to Roth.
- Generally taxable as income.

Roth Conversion Deep Dive (Agenda)

- What are the effects (pros and cons) of a Roth conversion? How do we decide whether to do one?
- What can we hope to achieve with a Roth conversion plan? (What metrics will be improved?)
- How does a Roth conversion plan fit into an overall retirement tax plan?

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Primary Effects of a Roth Conversion

1. Pay tax now instead of later

2. Use taxable account dollars to “buy more” Roth space

3. Reduce future RMDs (which can reduce future tax drag)

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Pay Tax Now Instead of Later

- This can be helpful or harmful.
- Depends on:
  - Current marginal tax rate (tax rate paid on conversion)

    vs.
  - Future marginal tax rate (tax rate paid on these dollars later, whenever they come out of the account later, if you don't convert them).
- Current rate is lower: helpful
- Current rate is higher: harmful

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Pay Tax Now Instead of Later (Caveats)

Marginal tax rate is ***not*** necessarily the same as tax bracket!

- Premium tax credit
- Social Security taxation
- Medicare IRMAA
- Anything that “phases in” or “phases out” based on income

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Pay Tax Now Instead of Later (Caveats)

Marginal tax rate often increases after one spouse dies.

Reason: Standard deduction ½ as large. Tax brackets have ½ as much room in them (through 32% bracket). But income falls by less than 50%.

Implication: may want to prioritize Roth conversions while both spouses are still alive.

Pay Tax Now Instead of Later (Caveats)

"Future tax rate" may not be *your* future tax rate.

It could be the tax rate your heir(s) would pay on distributions from an inherited IRA.

- Number of beneficiaries?
- Careers?

Pay Tax Now Instead of Later (Caveats)

To the extent you plan to use QCDs or leave tax-deferred dollars to charity at your death, the future tax rate is zero!

Makes Roth conversions much less desirable.

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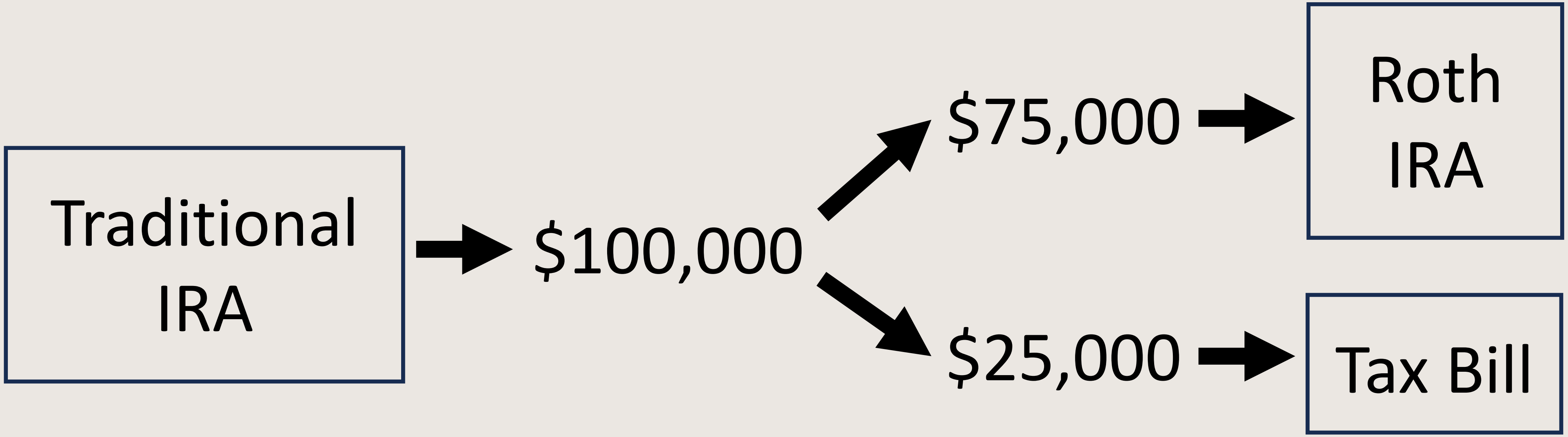
Instead of this…

Traditional IRA → $100,000

Instead of this…



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…we're doing this.

Traditional IRA → $100,000 → Roth IRA

Taxable Account → $25,000 → Tax Bill

Use Taxable $ to "Buy More" Roth Space

Does not apply if you have no taxable account dollars to use.

If applicable, it *is* a point in favor of Roth conversions.

Reason: taxable accounts have tax drag. Roth accounts don't.

Use Taxable $ to “Buy More” Roth Space

In taxable accounts, we have to pay tax on interest every year, dividends every year, capital gains when selling.

In Roth, we don’t have to pay those taxes. Literally earn a greater rate of return in Roth accounts.

Small difference, compounded over many years, has huge impact. (Just like expense ratios.)

Use Taxable $ to “Buy More” Roth Space

Exactly *how* beneficial varies based on circumstances.

How long will the money stay in the Roth?

- Longer = more beneficial. (More years of benefitting from tax-free growth.)

This could be “time until you spend the dollars” or “time until the dollars are distributed to heirs.”

Your age and health can be major factors.

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Use Taxable $ to "Buy More" Roth Space

Present Value	$1.00	$1.00
Rate of Return	4%	3.5%
Years	40	40
End Value	$4.80	$3.96

21% more in Roth!

Present Value	$1.00	$1.00
Rate of Return	4%	3.5%
Years	50	50
End Value	$7.11	$5.58

27% more in Roth!

This effect is often more impactful than the "pay tax now vs. pay tax later" effect.

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Reduce RMDs (Reduce Future Tax Drag)

Conversions reduce your future RMDs because Roth accounts don’t have RMDs during the original owner’s lifetime.

Reduce RMDs (Reduce Future Tax Drag)

We're *not* talking about the tax paid on the RMDs themselves. (That would fall under effect #1.)

We're talking about what happens to unspent RMD dollars?

- Usually they're reinvested in a taxable brokerage account, where they incur ongoing tax costs.
- Conversion lets you avoid that tax, because the dollars would be in a Roth IRA. (No RMD.)

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Reduce RMDs (Reduce Future Tax Drag)

Not always applicable.

If you’re going to spend your entire RMD every year (or donate via QCD), this effect isn’t applicable.

If applicable, this effect *is* a point in favor of Roth conversions.

Reduce RMDs (Reduce Future Tax Drag)

Exactly *how* beneficial depends on how long the money will stay in the Roth.

Again, the longer the money will stay in the Roth, the more beneficial.

Relevant period is from start of RMDs to 10 years after death.

Your health is a major factor.

Primary Effects of a Roth Conversion

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What Roth Conversions Are Likely (And Unlikely) to Achieve

A tax-efficient *spending* plan often improves financial security in retirement:

- Reduces probability of portfolio depletion
- In portfolio depletion scenarios, they happen later.

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What Roth Conversions Are Likely (And Unlikely) to Achieve

Roth conversions generally *don't* have those effects. Roth conversions do not typically improve financial security in retirement.

What Roth Conversions Are Likely (And Unlikely) to Achieve

Why don’t Roth conversions typically improve financial security in retirement?

Problems Roth Conversions Solve

- RMDs
- Tax drag in taxable accounts

Likely Causes of Portfolio Depletion

- Sequence of returns risk
- Spending shocks

What Roth Conversions Are Likely (And Unlikely) to Achieve

So why bother with a Roth conversion?

In the case of a smart conversion plan, they improve the after-tax bequest that's likely to be left to heirs. (And they do that without changing financial security in either direction.)

Which Accounts to Spend From?

Tax-deferred (a.k.a. “traditional” or “pre-tax”)

Roth

Taxable (anything that isn’t a retirement account)

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Retirement Tax Plan Summary

1. First priority for spending each year: checking, savings, taxable brokerage assets with no tax-cost to sell.

2. If you need to spend more in a given year:

   - Appreciated investments in taxable accounts likely best to spend next (if unlikely to donate or bequeath them soon).
   - Spend tax-deferred if current marginal tax rate < future marginal tax rate.
   - Spend Roth if current marginal tax rate > future marginal tax rate.

3. Fill any remaining low-tax-rate space with Roth conversions.

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Which Accounts to Spend From?

Example

- Which dollars to use for next $1,000 of spending?
- Haven’t yet used up standard deduction for the year (0% tax rate).

Which Accounts to Spend From?

Option A

- Spend $1,000 from tax-deferred.

Option B

- Spend $1,000 from taxable account (checking/savings).
- Do $1,000 Roth conversion.

In both cases:

Spent $1,000.

Created $1,000 of gross income, but $0 tax.

$1,000 less in tax-deferred than previously.

Which Accounts to Spend From?

Option A **$1,000 more in checking (didn't spend it)**
- Spend $1,000 from tax-deferred.

Option B **$1,000 more in Roth**
- Spend $1,000 from taxable account (checking/savings).
- Do $1,000 Roth conversion.

In both cases:
Spent $1,000.
Created $1,000 of gross income, but $0 tax.
$1,000 less in tax-deferred than previously.

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Which Accounts to Spend From?

Every year: spend “checking account” dollars first

- Earned income
- Social Security
- Pension/annuity income
- Interest and dividends from taxable accounts
- RMDs
- Investments in taxable accounts with unrealized losses or modest gains. (Low/no tax cost to sell.)

Track 1: Retirees and Near-Retirees

The History of Safe Withdrawal Rates

2:00 - 2:50 pm CDT

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