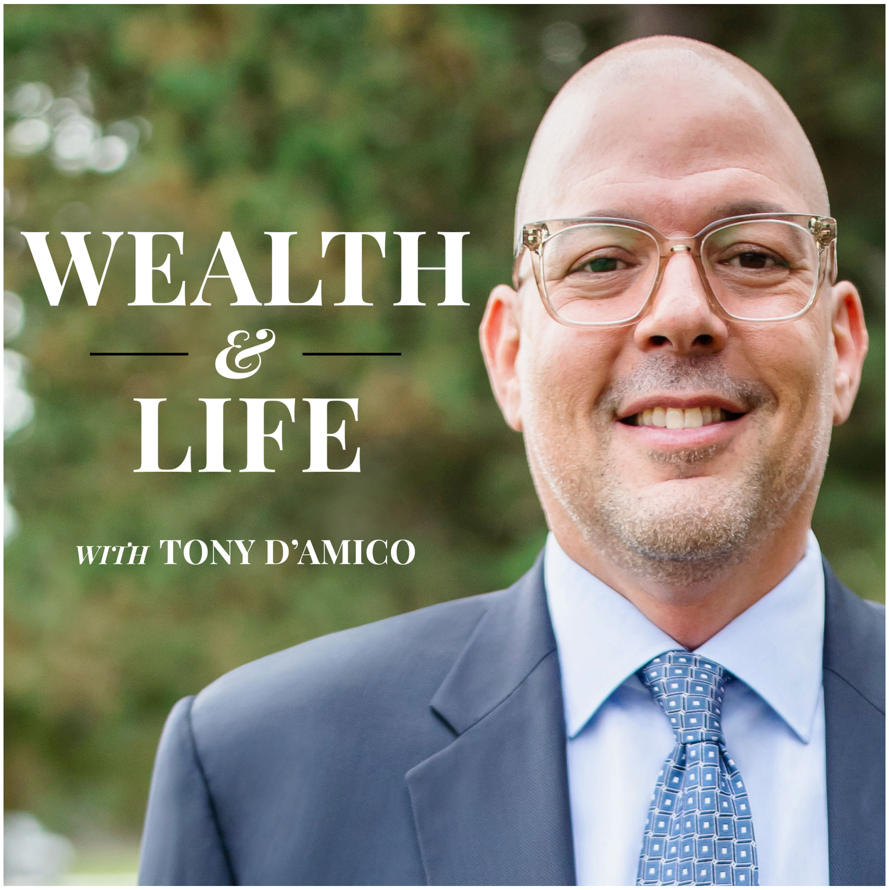
Ep #18: Roth Conversions: An Important Tax Planning Strategy



Full Episode Transcript

With Your Host

Tony D'Amico

***Wealth and Life* with Tony D'Amico**

Ep #18: Roth Conversions: An Important Tax Planning Strategy

Welcome to *Wealth and Life*, where you'll learn with financial planner, consultant, speaker, and business owner, Tony D'Amico. You'll hear stories from successful business owners and individuals about how they navigated the inevitable challenges that arose as they achieved each new level of success, and you'll get insights and strategies from leading wealth planning professionals on how to achieve your next level of success. Now here's your host, Tony D'Amico.

Tony D'Amico: Hi everyone, Tony D'Amico with Fidato Wealth. Thanks for joining me for this episode of Wealth and Life. And today I want to talk about a very important tax planning strategy. Let's talk about Roth conversions. So Roth conversions, we'll talk about what that is. But we're going to talk about it because it could possibly have a very big impact on your tax situation over the remainder of your life.

So as you probably know, an IRA is where you've made contributions typically on a pretax basis. So you're taking that tax deduction up front. The money grows tax deferred, but then when you make withdrawals, you pay income tax on the withdrawals at that point in time. Conversely, a Roth IRA or a Roth 401k, you're not taking the tax deduction up front. So you're paying your share of income tax on those funds. Then you make the contribution into either your Roth IRA or Roth 401k.

From that point forward, the funds will grow tax-free. And if you take the money out after age 59 and a half, there's also a five-year holding period on the principal, those funds come out income tax-free and penalty-free. So Roth IRAs, they grow compound tax-free and you can take income out from them tax free.

So typically during someone's working years, not always, it depends upon someone's situation, but if they're in a higher tax bracket and that's a relative distinction because tax brackets' tax code changes. Well, let's just say you're in a 28% tax bracket during your working years, you may want to contribute to an IRA to get the 28% savings on that contribution amount. So you might make that contribution into your IRA or 401k. So let's say that your scenario, you're in a higher tax bracket during your working years, you want to lower your tax rate. But then when you retire, you're likely going to be in a lower tax bracket. So identifying the years that you're going to have a low tax bracket is really important.

So in this scenario then, let's say somebody retired and they're not starting social security yet. Perhaps they have a pension, but it's not going to be started maybe for a few years. There's going to be room in the lower tax brackets. And you can take advantage of that by taking a portion of the IRA and converting it to the Roth IRA.

So for example, you could fill up the 22% tax bracket, and the amount in that tax bracket is going to depend upon if you're married, filing jointly, if you're married, filing individually, if you're single, et cetera. But let's just say that the married, filing jointly tax bracket goes up to, I'm going to say $170,000, just to use a number. So that you can have up to $170,000 of income and pay 22% tax bracket. So if you don't have obviously $170,000 of income, you can take your IRA and convert up to that amount, and pay that amount in income tax on those funds.

So when would that be an advantageous is the next question. So why are we even thinking about paying 22% on income tax now, if we can continue to defer it? So with an IRA or 401k, you can delay taking what's called your required minimum distributions until age 72. So that's where the rubber meets the road. So you really want to know, and this is something that we do for our clients, is we do a long-term tax projection over the next 20, 30 years. And we're looking at, okay, what is their income tax rate projected to be at retirement, given their financial plan and everything we know now about their financial plan and the assumptions being used. But if they're going to retire and we see that they're in a lower tax bracket, but if they did nothing at 72 when they have to take the required minimum distribution, if it pushes them up into the 33% tax bracket, that's when we can determine if that makes sense.

So you know the saying, it's either pay now or pay later. So we have had plenty of clients over the years where especially with these tax codes that are lower historically, they've filled up the 22% bracket, sometimes even the 24% bracket, but there's more calculations involved there and I can explain why. But they fill the 22% bracket because they're going to be at a higher tax bracket in the future.

And so with the use of quality financial planning software, we can run your financial plan and know what is the total of your income taxes that you'll pay if you do know Roth conversions, versus what is the total, what your income taxes that you would pay, if you did Roth conversions at whatever tax bracket we decide is optimal. So every scenario is different, but I've seen cases where people have saved $300,000 in income taxes over the long-term. I've seen people save $1.7 million of income taxes over the long-term. It depends.

So obviously people do have a growing tax problem with their IRAs. So the question is, it's a game of chess. When do we pay the taxes? You have to make a decision, too, is do you feel like tax rates are going to go lower or higher in the future? So everyone has a different thought there. I will say a lot of people feel like tax rates could go higher in the future.

So that's really what it comes down to is how much in taxes will you pay if you do nothing versus how much in taxes will you pay if you do Roth conversions. Now, there's other factors to consider which I'll kind of give you an overview, but nonetheless, again, this could be a very impactful strategy if it's the right scenario for you.

So this is typically done over the course of many years, as you can tell. So you want to fill the lower tax brackets when available. And there could be a period of five years, there could be a period of seven years, there could be a period longer or shorter. So it's very time sensitive, it's very opportunistic. We always utilize a CPA to run the calculations to determine how much can be converted.

Now, there are certain income thresholds that once you cross them, and this applies if you're within two years of Medicare. So if you start Medicare at 65, for example, this starts effective 63. If your income is above a certain threshold, it will cause Medicare premiums to be higher. So if you convert too much of your traditional IRA to a Roth, it could cause that implication, which is why we always measure twice and cut once.

So we do have some cases where it makes sense for someone to pay that extra Medicare cost because their future tax rate is very high. Okay. So they're saying, yes, I want to fill the 24% bracket now. I know it's going to cause Medicare premiums to go up, but it's all about the best net result to their bottom line over the long-term, over a 10, 20 year plus period of time.

So some other important considerations is where will the income tax be paid for? Will it be paid for... Do you have funds outside of the IRA, which is the most ideal spot is to pay for the taxes with funds outside of the IRA. That way all the IRA can go into the Roth. We don't want to disrupt that tax-free compounding. So if we can leave those IRA assets undisturbed and they all go to the Roth IRA, that would be the most ideal scenario.

Other considerations are, is how many years can you do the conversions? How much of a conversion each year are you anticipated to do? And how much of your IRA will be converted to a Roth in that period of time? So I could think of an example where somebody had an IRA, they already had some Roth IRA assets, and they pretty much just needed... They had actually five years of low income taxes to do the conversions. And the tax code was stable during this period of time. There wasn't a threat really, an immediate threat that the tax rates could change. You never know, but that was the environment then.

So rather than we could have actually did more per year, but we said, okay, well, let's actually spread it out actually over five years. So we don't need to go into the 24% bracket in that scenario. We could just fill the 22% because there was enough time. So knowing how much needs to be converted, how much per year, and again, the number of years available again, to maximize that impact.

So another factor that can affect Roth conversions is we always look to do Roth conversions when there's a sharp decline in the market because you're converting shares. So if you can convert more shares at a cheaper price, that's even better for a Roth conversion. Having said that, we don't want to let the tail wag the dog, if you will. So if you can fill the 22% bracket and you feel like that's a potential bargain with tax rates moving forward, we want to take the tax savings that are available to you, the anticipated tax savings.

This Roth conversion strategy too, it also impacts other planning within a plan. So if your biggest frenemy is taxes, and you have this conversion opportunity that may affect when to claim Social Security. So sometimes, again, I would say rather often, but not always, sometimes it may make sense for somebody to defer Social Security so it continues to give them more room to do these Roth conversions.

So again, we have to look at for our clients, what makes the best and biggest impact, and then how do we optimize things around that so our clients are getting the most ideal outcome over the next, let's say 10, 20 year period. So this is really a game of chess. How do these decisions affect one another? How will this affect against Social Security claiming? How would it affect pension claiming? How does it impact your retirement income distribution plan?

Because at some point, you're going to retire if you haven't retired already. So about a third of our clients are retired, two thirds aren't. But at that point in time of retirement, we're putting together a retirement income plan for you based upon the level of income you want to maintain. So again, having all these pieces, mitigating taxes, helping you, I would say, optimize your net worth at the end of the day, it's about what you keep. It's not just about the amount of return. It's about what you keep after taxes. So looking at all those pieces and putting them together in the most optimal way is the task at hand.

So that's a little bit about Roth conversions. I hope you enjoyed today's episode. If you have questions I would love to hear from you. Feel free to send us an email at sayhello@fidatowealth.com. Thanks so much. Have a great day. Bye-bye now.

Do you want even more ideas, tools, and resources of how to achieve the next level of success in your wealth planning? Check out wealthandlife.com, where Tony will cover the latest trends and wealth planning best practices for successful business owners, families approaching retirement, and comprehensive wealth management. By subscribing to the Wealth and Life podcast, keep up to date with future episodes. Get it all now at wealthandlife.com.

Ep #18: Roth Conversions: An Important Tax Planning Strategy