15 Roth Conversion Scenarios

Guidelines for Analyzing Your Clients’ Conversion Options

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Horsesmouth
3 Key Variables

- Tax rate now vs. later
- Source of funds to pay conversion taxes
- Distributions – when and how much?
Why run Roth conversion scenarios?

- Isolate variables
- Test assumptions
- Replace hunches with educated guesswork
Using the Roth Conversion with Distributions Calculator

- Obtain client information
- Make assumptions
- Crunch the numbers
- Compare the results
- Recommend either Roth conversion or no conversion
Information you need to obtain

- Birthdate of client
- Birthdate of beneficiary
- Value of accounts eligible for conversion
  - IRAs
  - Qualified plans
- Basis, if any
- Availability of liquid assets to pay the conversion taxes
Assumptions you need to make

- Client’s taxable income in year(s) conversion is reported
- Client’s tax rate in year(s) distributions are taken
- Rate of return on invested assets
- Age distributions will start
- Amount of distributions
- Inflation rate on distributions
- Life expectancy of client
- Life expectancy of beneficiary
Scenarios 1-3
Worst-case tax situation

- Conversion taxed at 35%
- Distributions taxed at 15%
Assumptions for Scenarios 1-3

- Client birthdate 1/15/1960 – age 50
- Amount to convert: $100,000 (no basis)
- Rate of return: 4%
- Current income $400,000 (35% tax bracket)
- Marginal tax rate on distributions: 15%
- Marginal tax rate for taxable investments: 15%
- Marginal tax rate for beneficiary: 15%
Scenario 1
Worst case

- Pay conversion tax ($35,000) from inside IRA (10% penalty)
- Distributions begin at 70
- Amount of initial distribution:
  - $7,997 from traditional IRA (RMD)
  - $6,797 from Roth (same as after-tax RMD)
Results for Scenario 1

At retirement in 20 years, after tax net impact of Roth conversion:

- Assuming lump sum distribution of balance: -$52,344
- Assuming distributions through owner’s lifetime: -$59,139
- Assuming distributions through owner’s and beneficiary’s lifetime: -$59,139
Scenario 2

- Same as Scenario 1 except conversion taxes are paid outside the IRA
Results for Scenario 2

At retirement in 20 years, after tax net impact of Roth conversion:

- Assuming lump sum distribution of balance: -$35,442
- Assuming distributions through owner's lifetime: -$29,702
- Assuming distributions through owner's and beneficiary's lifetime: -$26,894
Scenario 3

- Same as Scenario 2 but distributions start at 80
- Distributions = 4% of account value + 3%/year
- Value of Roth at age 79 = $324,338
- 4% of $324,338 = $12,973
Results for Scenario 3

- Assuming lump sum distribution of balance: $48,673
- Assuming distributions through owner's lifetime: $53,301
- Assuming distributions through owner's and beneficiary's lifetime: $63,206
Conclusions from Scenarios 1-3

- Conventional wisdom that client must be in a higher bracket in retirement is wrong
- Roth can still make sense as long as other variables are favorable
- Deferral of distributions is key
- The most unfavorable tax scenario can be overcome if distributions are deferred
Scenarios 4-6
Conversion taxes paid from inside or outside the IRA

- Scenario 4: Worst case
  - Taxes paid from inside the IRA
  - Distributions start in 5 years
Assumptions for Scenarios 4-6

- Client birthdate 1/15/1945 – age 65
- Amount to convert: $100,000 (no basis)
- Rate of return: 4%
- Current income $100,000 (33% tax bracket with conversion)
- Pay conversion tax ($33,000) from inside IRA
- Marginal tax rate on distributions: 28%
- Marginal tax rate for taxable investments: 28%
- Marginal tax rate for beneficiary: 28%
Assumptions for Scenario 4

- Distributions begin at 70 (in 5 years!)
- Amount of initial distribution:
  - $7,997 from traditional IRA (RMD)
  - $5,758 from Roth (same as after-tax RMD)
Results for Scenario 4

- Assuming lump sum distribution of balance: -$1,144
- Assuming distributions through owner's lifetime: -$1,381
- Assuming distributions through owner's and beneficiary's lifetime: -$1,381
Scenario 5: Same as Scenario 4, except taxes are paid outside the IRA
Scenario 6: Same as Scenario 4, except distributions start at 75
Conclusions from Scenarios 4-6

- Conventional wisdom that conversion taxes must be paid from outside the account is sometimes wrong.
- Again, distributions are key – depends on number of years before distributions start.
- If distributions can be deferred, Roth can make sense even if taxes are paid from inside the IRA.
- However . . . Wherever possible, clients should be encouraged to pay taxes with outside funds. This essentially constitutes an additional contribution to tax-favored plans.
Scenarios 7-9
Early vs. Later Distributions

- Scenario 7
  - Start at 70, distributions from Roth equal after-tax RMDs (apples to apples)

- Scenario 8
  - Start at 80, 4% of starting value increased by 3%/year (more realistic distribution plan that taps Roth last)

- Scenario 9
  - Start at 95 (after one distribution account passes to beneficiary)
Assumptions for Scenarios 7-9

- Client birthdate 1/15/1950 – age 60
- Amount to convert: $250,000 (no basis)
- Rate of return: 4%
- Current income $100,000 (33% tax bracket with conversion)
- Pay conversion tax ($78,450) from inside IRA
- Marginal tax rate on distributions: 28%
- Marginal tax rate for taxable investments: 28%
- Marginal tax rate for beneficiary: 28%
Scenario 7
Distributions start at 70
Scenario 8
Distributions start at 80
4% of account value + 3%/year
Scenario 9
Distributions start at 95
Why Distributions Make Such a Difference

- Calculator considers net present value of reinvested distributions
- Investment returns on reinvested RMDs from traditional IRA are taxable
- Investment returns on assets that remain in the Roth are tax-free
- Roth maximizes tax deferral on assets that would otherwise be paid out in RMDs
- The longer assets remain in the Roth, the greater the value of the tax deferral
Distributions are Key to Roth Analysis

- Roth analysis must be integrated with the client’s:
  - Retirement income plan
    - When will Roth distributions start?
    - What amount will Roth distributions be?
  - Estate plan
    - What is the client’s life expectancy?
    - How much does client want to leave to heirs?
Retirement Income Planning
General Principles

- Determine expenses
  - Mandatory
  - Discretionary

- Determine income sources
  - Annuity income for mandatory expenses
    - Social Security
    - Pensions
    - Commercial annuities
  - Portfolio withdrawals for discretionary expenses and inflation protection
    - Taxable accounts (tap first)
    - Tax-deferred accounts
    - Tax-free (Roth) accounts (tap last)
Estimating Roth Distributions

- Prioritize distributions from other accounts: Tap taxable and tax-deferred assets first
- Defer and minimize Roth distributions to preserve tax-free assets for the future
- If possible, view Roth as “rainy day fund”
- The longer the Roth can build up, the more tax-free income the client will be able to enjoy
- The longer distributions can be deferred, the more sense it makes to convert to a Roth now
Estate Planning

- Maximum benefit of Roth conversion occurs when distributions are deferred to next generation
- However . . . must consider client’s life expectancy
Scenario 10
65-year-old client lives 18 more years (to age 83)

At retirement in 18 years, after tax net impact of Roth conversion:
- Assuming lump sum distribution of balance: $173,717
- Assuming distributions through owner's lifetime: $164,998
- Assuming distributions through owner's and beneficiary's lifetime: $235,175
Scenario 11
65-year-old client lives 5 more years (to age 70)

At retirement in 5 years, after tax net impact of Roth conversion:
- Assuming lump sum distribution of balance: -$5,251
- Assuming distributions through owner’s lifetime: -$4,323
- Assuming distributions through owner’s and beneficiary’s lifetime: $23,369

$23,369
Guidelines for Running Scenarios with Roth Conversion Calculator

- Gather information from client
- Work with client on setting assumptions for:
  - Amount of conversion (full or partial)
  - Tax rates (now and later)
  - Life expectancy
  - Rate of return
  - Distribution plans
- Issue disclaimer: analysis uses assumptions that are unknowable and may turn out to be incorrect
Scenarios Used in Client Seminar

- Mary, age 40
- Michael, age 50
- Robert, age 60
- Kathleen, age 70
Mary, age 40

- Current income $80,000 (28% tax bracket)
- IRA = $100,000
- IRA annual growth rate: 4%
- No outside funds to pay conversion taxes
- Plans to retire at age 70 and immediately begin IRA withdrawals
- Projected future tax bracket: 25%
Roth Conversion Analysis for Mary

- Assuming lump sum distribution of balance: -$9,567
- Assuming distributions through owner's lifetime: -$12,012
- Assuming distributions through owner's and beneficiary's lifetime: -$12,012
Roth Conversion Analysis for Mary

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Traditional IRA</th>
<th>Roth IRA**</th>
<th>Conversion Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assuming lump sum distribution of balance:</td>
<td>$243,254</td>
<td>$233,686</td>
<td>decrease $9,568</td>
</tr>
<tr>
<td>Assuming distributions through owner's lifetime:</td>
<td>$276,304</td>
<td>$264,292</td>
<td>decrease $12,012</td>
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<tr>
<td>Assuming distributions through owner's and beneficiary's lifetime:</td>
<td>$276,304</td>
<td>$264,292</td>
<td>decrease $12,012</td>
</tr>
</tbody>
</table>

*This is the total value in 30 years (at your retirement) of your ending account balances and future distributions. Distributions that happen after your retirement, and balances at the end of your lifetime or your beneficiary's lifetime, are discounted by your annual after-tax rate of return in retirement of 3.00%. This is the Net Present Value at retirement of all future distributions and balances.

**This analysis assumes you are paying all taxes and penalty due by withdrawing funds from your account. This reduces the Roth account balance that will be converted.

Recommendation: No Roth Conversion
Michael, age 50

- Current income $250,000 (33% tax bracket)
- IRA = $250,000
- IRA annual growth rate: 4%
- Conversion taxes to be paid outside the IRA
- IRA distributions to start at 80
- Projected future tax bracket: 28%
Roth Conversion Analysis for Michael

- Assuming lump sum distribution of balance: $247,759
- Assuming distributions through owner's lifetime: $308,050
- Assuming distributions through owner's and beneficiary's lifetime: $383,409
Roth Conversion Analysis for Michael

<table>
<thead>
<tr>
<th></th>
<th>Traditional IRA**</th>
<th>Roth IRA</th>
<th>Conversion Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assuming lump sum distribution of balance:</td>
<td>$563,092</td>
<td>$810,851</td>
<td>increase $247,759</td>
</tr>
<tr>
<td>Assuming distributions through owner's lifetime:</td>
<td>$612,592</td>
<td>$920,642</td>
<td>increase $308,050</td>
</tr>
<tr>
<td>Assuming distributions through owner's and beneficiary's lifetime:</td>
<td>$612,592</td>
<td>$996,001</td>
<td>increase $383,409</td>
</tr>
</tbody>
</table>

*This is the total value in 30 years (at your retirement) of your ending account balances and future distributions. Distributions that happen after your retirement, and balances at the end of your lifetime or your beneficiary's lifetime, are discounted by your annual after-tax rate of return in retirement of 2.88%. This is the Net Present Value at retirement of all future distributions and balances.

**This analysis assumes you are paying all taxes due with money outside of your retirement account. The totals for the traditional IRA include your tax payment and the amount you would have earned if you had invested your tax payment in an ordinary taxable account.

Recommendation: Convert to a Roth now
Robert, age 60

- Current income $80,000 (25% tax bracket)
- IRA = $500,000
- IRA annual growth rate: 4%
- Conversion taxes to be paid outside IRA
- Plans to start IRA distributions at 75
- Projected future tax bracket: 28%
Roth Conversion Analysis for Robert

At retirement in 15 years, after tax net impact of Roth conversion:

- Assuming lump sum distribution of balance: $114,496
- Assuming distributions through owner’s lifetime: $182,333
- Assuming distributions through owner’s and beneficiary’s lifetime: $220,284
Roth Conversion Analysis for Robert

<table>
<thead>
<tr>
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<th>Roth IRA</th>
<th>Conversion Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assuming lump sum distribution of balance:</td>
<td>$785,974</td>
<td>$900,470</td>
<td>increase $114,496</td>
</tr>
<tr>
<td>Assuming distributions through owner's lifetime:</td>
<td>$861,573</td>
<td>$1,043,906</td>
<td>increase $182,333</td>
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<tr>
<td>Assuming distributions through owner's and beneficiary's lifetime:</td>
<td>$861,573</td>
<td>$1,081,857</td>
<td>increase $220,284</td>
</tr>
</tbody>
</table>

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**This analysis assumes you are paying all taxes due with money outside of your retirement account. The totals for the traditional IRA include your tax payment and the amount you would have earned if you had invested your tax payment in an ordinary taxable account.

Recommendation: Convert to a Roth now
Kathleen, age 70

- Current income $60,000 (25% tax bracket)
- IRA = $1,000,000
- IRA annual growth rate: 4%
- Conversion taxes to be paid outside IRA
- IRA distributions to start at 85
- Projected future tax bracket: 28%
Roth Conversion Analysis for Kathleen

At retirement in 15 years, after tax net impact of Roth conversion:

- Assuming lump sum distribution of balance: $648,388
- Assuming distributions through owner's lifetime: $753,728
- Assuming distributions through owner's and beneficiary's lifetime: $906,839

Distributions are shown in thousands of dollars.
Roth Conversion Analysis for Kathleen

<table>
<thead>
<tr>
<th>Assumption</th>
<th>Traditional IRA**</th>
<th>Roth IRA</th>
<th>Conversion Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assuming lump sum distribution of balance:</td>
<td>$1,152,555</td>
<td>$1,800,943</td>
<td>increase $648,388</td>
</tr>
<tr>
<td>Assuming distributions through owner's lifetime:</td>
<td>$1,231,535</td>
<td>$1,985,263</td>
<td>increase $753,728</td>
</tr>
<tr>
<td>Assuming distributions through owner's and beneficiary's lifetime:</td>
<td>$1,231,535</td>
<td>$2,138,374</td>
<td>increase $906,839</td>
</tr>
</tbody>
</table>

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**This analysis assumes you are paying all taxes due with money outside of your retirement account. The totals for the traditional IRA include your tax payment and the amount you would have earned if you had invested your tax payment in an ordinary taxable account.

Recommendation: Convert to a Roth now
## Assumptions and Recommendations

<table>
<thead>
<tr>
<th>Assumption</th>
<th>Convert to Roth now?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax bracket in retirement will likely be higher than it is now</td>
<td>Yes</td>
</tr>
<tr>
<td>Funds are available outside the IRA to pay conversion taxes</td>
<td>Yes</td>
</tr>
<tr>
<td>Distributions will likely be later and smaller than RMDs</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax bracket in retirement will likely be lower than it is now</td>
<td>Maybe – depends on distribution plans</td>
</tr>
<tr>
<td>Taxes paid with funds from inside the IRA</td>
<td>Maybe – depends on distribution plans</td>
</tr>
<tr>
<td>No, if under 59-1/2 (10% penalty on amount withdrawn for taxes)</td>
<td></td>
</tr>
<tr>
<td>Distributions will start in 5-10 years</td>
<td>No</td>
</tr>
</tbody>
</table>
Roth Conversion Breakeven Analysis

- Excel worksheet calculates the crossover age at which the Roth exceeds the traditional IRA
- Considers year-by-year cash flows, not net present value
- May be easier for clients to understand
Next Week: Session Two
How to Develop an Effective Roth Conversion Plan

- What to convert
- How much to convert
- When to convert
- How to convert
- Whether or not to recharacterize