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To Convert or Not to Convert, That is the Question

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Many clients pose the question, "should I convert to a Roth IRA?" Even more financial professionals ponder it. The answer is mathematical, actuarial, political, and somewhat speculative. Nevertheless, with sufficient analysis it is often, if not usually, possible to prove quantitatively most clients will benefit from a partial conversion of some size.

In 1997, when I wrote *A CPA's Guide to Making the Most of the New IRAs* for the American Institute of Certified Public Accountants, I identified four reasons to convert a traditional IRA to a Roth IRA which remain valid to this day:

1) To take advantage of favorable tax attributes (such as charitable deductions carryforwards,
   Net Operating Loss (NOL) carryforwards, investment tax credits, etc…);
2) Suspension of the lifetime required minimum distribution (RMD) rules for Roth IRAs;
3) Greater growth potential, to the extent that outside sources (e.g.,, taxable brokerage accounts) are used to pay for the taxes due on the Roth IRA conversion; and
4) The payment of income tax prior to the imposition of estate tax allows for greater wealth to be transferred to future generations – even considering the IRC § 691(c) deduction

Over the years we have also observed that a Roth conversion is an effective way to hedge against the increase in tax rates after a spouse dies and had the opportunity to analyze the amount of wealth lost in pre-tax accounts after Congress increases tax rates.

Understanding Roth IRA conversions has never been easy and never will be.. Over the years, I have had the privilege of teaching and writing on Roth IRA conversions, read many books and articles and attended various seminars on this subject and have come up with a few general "rules of thumb." I have found that the best way to truly understand a Roth IRA

conversion and take advantage of its benefits is through fairly basic spreadsheet analyses and working through a checklist.

**The many variables with a Roth IRA conversion lend themselves to the development of several options before arriving at an "optimum" scenario. Nevertheless, we have generally found that the following key factors need to be identified and addressed in order to best analyze a Roth IRA conversion:

1) Asset mix (*i.e.,* qualified versus nonqualified, liquid versus illiquid)
2) Traditional IRA balance
3) Time horizon
4) Current and future cash flow needs
5) Current marginal tax rate versus projected future marginal tax rate
6) Wherewithal to pay the income tax with nonqualified funds
7) Estate planning objectives and opportunities

Based on the above factors, we have been able to isolate the following four types of Roth IRA conversions:

1) *Strategic Conversions*—take advantage of a client's long-term wealth transfer objectives
2) *Tactical Conversions*—take advantage of short term client-specific income tax attributes that are set to expire
3) *Opportunistic Conversions*—take advantage of short-term stock market volatility, sector rotation and rotation in asset classes
4) *Hedging Conversions*—take advantage of projected future events that will result in the client being subject to higher tax rates within the near future

Strategic Conversions

An ideal "strategic conversion" candidate would be a client who:

- has "outside funds" (*e.g.,* nonqualified liquid assets) to pay the income tax on the conversion;
- will not need the Roth IRA to meet his/her annual living expenses;
- desires to leave a tax-free asset to children or grandchildren; and

- expects to be in the same or higher tax bracket in future tax years.

In this situation, the Roth IRA is viewed more as a wealth transfer tool than as a retirement income vehicle. Because Roth IRA owners are not subject to the "required minimum distribution" (RMD) rules, the funds within the account are allowed to grow tax free. Over a period of years, this growth can be exponential. Further, although Roth IRA beneficiaries are required to take RMDs each year, these withdrawals will be tax free. Thus, the Roth IRA is the perfect retirement asset to transfer the greatest amount of wealth.

Notwithstanding the above, there are three factors critical to analyzing strategic conversions: (1) tax rate differential, (2) use of outside funds to pay income tax, and (3) time horizon.

The first factor is the client's current and projected future income tax brackets. From a mathematical perspective, assuming all other factors are held constant (and the income tax liability is paid with funds inside of the IRA), if a client's current and future tax rates are the same, the client will be in the same economic position by converting to a Roth IRA as he would be in if he left the assets in a traditional IRA.l.

Example 1

Michael, age 40 and married, is considering converting $100,000 to a Roth IRA. At the present time, Michael and his wife are in the 25-percent tax bracket and expect to be in that tax bracket for all future tax years. Given these assumptions, the amount of IRA assets available for Michael in 30 years is as shown in Figure 1.

Figure 1

	Traditional IRA	Roth IRA

Pre-Tax Account Balance (Current)	$100,000	$100,000
Less: Income Tax on Roth IRA Conversion @ 25%	$ –	(25,000)
After-Tax Account Balance (Current)	$100,000	$75,000
Growth Factor	400%	400%
Pre-Tax Account Balance (Year 30)	$400,000	$300,000
Less: Income Tax on IRA Withdrawal @ 25%	(100,000)	$ –
After-Tax Account Balance (Year 30)	$300,000	$300,000

Another critical factor in analyzing strategic conversions is the ability to use outside funds to pay the income tax liability on a Roth IRA conversion. Again holding everything else constant, if the client has outside funds with which to pay the income tax liability on a Roth IRA conversion, she will be in a better economic position than if she had kept all the funds within the traditional IRA.

Example 2

Elizabeth, age 75 and single, has a $2 million traditional IRA and $800,000 in a taxable brokerage account (*i.e.*, outside funds). Elizabeth is subject a 40-percent marginal tax rate each year. Assuming an income tax rate on the conversion of 40-percent, a pre-tax growth rate in the IRA of nine-percent and an after-tax growth rate of 7.5 percent in the taxable brokerage account, the amounts of wealth Elizabeth will have in 10 years under the two scenarios are compared in Figure 2.

The final critical factor in analyzing strategic conversions is the client's time horizon. Obviously, the more time funds can grow in a tax-deferred environment, the better the economic result. Even in cases when the client expects to be in a lower tax bracket in the future, if the client has outside funds to pay the income tax on a Roth IRA conversion and has a long time horizon, it is possible that a Roth IRA conversion would be more effective.

Figure 2

	Do Nothing			Roth IRA Conversion			
	Traditional IRA	Brokerage Account	Total	Roth IRA	Brokerage Account	Total	Difference ($)
Pre-Tax Account Balance (Current)	$2,000,000	$800,000	$2,800,000	$2,000,000	$800,000	$2,800,000	
Less: Income Tax on Roth IRA Conversion @ 40%	$0	$0	$0	$0	-$800,000	-$800,000	
Less: "Built-in" Income Tax @ 40%	-$800,000	$0	-$800,000	$0	$0	$0	
After-Tax Account Balance (Current)	$1,200,000	$800,000	$2,000,000	$2,000,000	$0	$2,000,000	$0
Pre-Tax Account Balance (10 Years)	$4,734,727	$1,648,825	$6,383,553	$4,734,727	$0	$4,734,727	
Less: "Built-in" Income Tax @40%	-$1,893,891	$0	- $1,893,891	$0	$0	$0	
After-Tax Account Balance (Year 10)	$2,840,836	$1,648,825	$4,489,662	$4,734,727	$0	$4,734,727	$245,066

Example 3

Paul, age 45 and single, has a $400,000 IRA and $112,000 of nonqualified liquid assets. Right now, Paul is in the 28-percent tax bracket and expects to be in the 25-percent tax during his retirement years. Assuming a pre-tax growth rate in the IRA of seven percent and an after-tax growth rate of six percent in the taxable brokerage account, the amount of wealth Paul will have in the future is shown in Figure 3. Note that the benefit of a Roth conversion is less under these facts than under the facts of example 2 because Paul's tax rate drops during his retirement years.

Figure 3

	Do Nothing			Roth IRA Conversion				
	Traditional IRA	Brokerage Account	Total	Roth IRA	Brokerage Account	Total	Difference ($)	Difference (%)
Pre-Tax Account Balance (Current)	$400,000	$112,000	$512,000	$400,000	$112,000	$512,000		
Less: Income Tax on Roth IRA Conversion @ 28%	$ –	$ –	$ –	$ –	-$112,000	-$112,000		
Less: "Built-In" Income Tax @ 25%	(100,000)	$ –	(100,000)	$ –	$ –	$ –		
After-Tax Account Balance (Current)	$300,000	$112,000	$412,000	$400,000	$ –	$400,000	-$12,000	-2.91%
Pre-Tax Account Balance (Year 10)	$786,861	$200,575	$987,435	$786,861	$ –	$786,861		
Less: "Built-In" Income Tax @ 25%	(196,715)	$ –	(196,715)	$ –	$ –	$ –		
After-Tax Account Balance (Year 10)	$590,145	$200,575	$790,720	$786,861	$ –	$786,861	-$3,860	-0.49%

Pre-Tax Account Balance (Year 20)	$1,547,874	$359,199	$1,907,073	$1,547,874	$ –	$1,547,874		
Less: "Built-In" Income Tax @ 25%	(386,968)	$ –	(386,968)	$ –	$ –	$ –		
After-Tax Account Balance (Year 20)	$1,160,905	$359,199	$1,520,105	$1,547,874	$ –	$1,547,874	$27,769	1.83%
Pre-Tax Account Balance (Year 30)	$3,044,902	$643,271	$3,688,173	$3,044,902	$ –	$3,044,902		
Less: "Built-In" Income Tax @ 25%	(761,226)	$ –	(761,226)	$ –	$ –	$ –		
After-Tax Account Balance (Year 30)	$2,283,677	$643,271	$2,926,948	$3,044,902	$ –	$3,044,902	$117,954	4.03%

Tactical Conversions

“Tactical conversions” adhere to the same principles as strategic conversions, except that the Roth IRA in this type of conversions is used as a tool to realize short-term, unused special tax attributes. Such special tax attributes could include the following:

- Net Operating Loss (NOL) carryforwards
- Business and other ordinary losses
- Deductions and exemptions in excess of income
- Charitable contribution carryforwards
- Nonrefundable tax credits

In a typical tactical conversion scenario, the client is faced with the possibility of losing a favorable tax attribute within the current year or in the near future. In order to realize this favorable tax attribute, the client must generate taxable income. Thus, in this case, the client uses the Roth IRA conversion to “free up” the unrealized favorable tax attribute while at the same time paying little to no income tax on the Roth IRA conversion.

Example 4

In 2015, Tom and Mary Smith had the sources of income, deductions, exemptions and credits shown in Figure 4.

Figure 4

Interest	$1,600
Qualified dividends	$5,000
Long-term capital gain	$12,000
Partnership 1 income (active)	$30,000

Partnership 2 loss (active)	($20,000)
Standard Deduction	($12,600)
Exemptions (two personal, two dependency)	($16,000)
Taxable Income	$0
American Opportunity Tax Credit - Child #1	$2,500

Knowing that they would have zero taxable income in 2015 and will not be able to use the tax credit, Tom and Mary asked their CPA to determine how much they could convert to a Roth IRA without any income tax liability. Based on these facts, Tom and Mary's CPA determined that they could convert $22,817 to a Roth IRA without incurring any tax as shown in Figure 5.

Figure 5

Interest	$1,600
Qualified dividends	$5,000
Long-term capital gain	$12,000
Roth IRA conversion	$22,817
Partnership income (active)	$30,000
Partnership 2 loss (active)	($20,000)
Adjusted Gross Income (AGI)	$51,417
Less: Itemized deductions	(12,600)
Less: Personal & dependency exemptions	(16,000)
Taxable income	$22,817
Gross income tax	$2,500
Less: Education credits	(2,500)
Net income tax	$0

Opportunistic Conversions

An "opportunistic conversion" is another type of tactical conversion that takes advantage of short-term economic conditions that are expected to reverse over time. A classic example of this would be a situation where a client's IRA portfolio has languished recently due to a market correction, but is expected to turn around within the next year or two. Another example of an opportunistic conversion would be a situation where the client's IRA portfolio holds a stock or a fund that is expected to have rapid growth within the near future.

Example 5

In 2015, Carla, age 57 and married, has a traditional IRA worth $100,000 invested in a stock that is expected increase by 20-percent within a year. Assuming that Carla and her husband are going to be in the 33-percent tax bracket both at the time of conversion and at the time of withdrawal, Carla would save $6,600 ($100,000 x 0.2 x 0.33) in taxes by converting before the investment appreciates.

Hedging Conversions

As the name implies, a "hedging conversion" is a type of Roth IRA conversion that is done to hedge against some future event that could result in higher taxes. In a nutshell, there are two main kinds of hedging conversions:

1) Income tax hedging conversions
2) Estate tax hedging conversions

An income tax hedging conversion reduces the risk of higher income tax rates in the future. This commonly occurs when IRA-owners expect Congress to raise rates, receive a windfall, or expect their spouse to outlive them. The last situation is very common. It occurs because after the year of death the surviving spouse filing status will be single and therefore subject to substantially compressed tax brackets. Assuming that the surviving spouse has the same taxable income in future years as when the client was alive, her income tax liability will increase substantially. On the other hand, had the couple undertaken an IRA conversion before or in the year of the first death, their overall income tax liability could be substantially less.

Figure 6 is a summary of the tax brackets for the four main filing statuses.

Figure 6

	Single		Married Filing Jointly		Married Filing Separately		Head of Household	
Tax Rate	**Floor**	**Ceiling**	**Floor**	**Ceiling**	**Floor**	**Ceiling**	**Floor**	**Ceiling**
10.00%	$ -	$9,225	$ -	$18,450	$ -	$9,225	$ -	$13,150
15.00%	$9,226	$37,450	$18,451	$74,900	$9,226	$37,450	$13,151	$50,200
25.00%	$37,451	$90,750	$74,901	$151,200	$37,451	$75,600	$50,201	$129,600

28.00%	$90,751	$189,300	$151,201	$230,450	$75,601	$115,225	$129,601	$209,850
33.00%	$189,301	$411,500	$230,451	$411,500	$115,226	$205,750	$209,851	$411,500
35.00%	$411,501	$413,200	$411,501	$464,850	$205,751	$232,425	$411,501	$439,000
39.60%	$413,201	$413,201<	$464,851	$464,851<	$232,426	$232,426<	$439,001	$439,001<

Example 6

Carl and Nancy, ages 70 and 72, respectively, have been retired for several years and have the sources of income on a yearly basis shown in Figure 7. In addition, Carl and Nancy had the retirement assets shown in Figure 7.

Figure 7

Traditional IRA distributions	$50,000
Social Security (gross) - Carl	$20,000
Social Security (gross) - Nancy	$16,000

Figure 8

Traditional IRA	$800,000

In 2015, Carl was diagnosed with a medical condition whereby it was ascertained that he would not be expected to live much more than three years. Because of this situation, Carl and Nancy sought tax planning advice.

Upon reviewing Carl and Nancy's financial position and cash flow needs, their advisor noted that their income tax liability will increase substantially after Carl's death. Note that they plan to undertake a spousal rollover at Carl's death and continue to draw at least $50,000 annually from their retirement account to pay for living expenses and their grandchildren's tuition.

After doing the math, the advisor determines that a significant portion of the $50,000 IRA distribution after Carl's death would be subject to the 25-percent marginal income tax rate, as opposed to their current marginal rate of 15-percent. The advisor therefore suggests that the couple undertake Roth conversions of $20,000 per year until Carl's death. By converting only $20,000 per year, all of the Roth IRA conversion income is taxed at Carl and Nancy's marginal income tax rate of 15 percent.

From 2015 until his death in 2017, Carl converted $20,000 to his Roth IRA each year, paying $3,000 ($20,000 x 0.15) of additional income tax on each conversion. In the years after Carl's death, Nancy was able to draw in part from her Traditional IRA and in part from the Roth IRA to continue her planned spending without exposure to the 25% bracket. This simple technique increases this couple's wealth by over $6,000 as shown in Figure 8.

Figure 8

	2015	2016	2017	Total
$20,000 Roth IRA conversion	$17,000	$17,000	$17,000	$51,000
No Roth IRA conversion	$15,000	$15,000	$15,000	$45,000

Like an income tax hedging conversion, an estate tax hedging conversion hedges against the possibility that the combined income and estate tax on a traditional IRA will be higher than converting to a Roth IRA.

In the context of traditional IRAs, qualified retirement plans and Roth IRAs, the gross value of these accounts will be included in the decedent's gross estate. However, even though these accounts are included in a decedent's gross estate, they will not receive a basis adjustment since they are deemed to be Income in Respect of a Decedent (IRD).

Because traditional IRAs and other qualified retirement plans are items of IRD, the Internal Revenue Code assesses an income tax on distributions that occur after the account owner's death. In these situations, where an estate tax has been imposed upon the same funds that are subject to income tax, an income tax deduction for the federal estate tax paid on IRD is designed to help mitigate the effect of double taxation. (This is commonly referred to as a "Code Sec. 691(c) deduction.") The calculation in Figure 9 outlines this concept.

Figure 9

Total Value of IRA Included in Taxable Estate	$1,000,000
State Death Tax @ 10%	(100,000)
Federal Estate Tax @ 40% (tax imposed net of state death tax $900,000)	(360,000)
Total Estate Taxes	(460,000)

Total IRA Value	$1,000,000
Less: Code Sec. 691 (c) Deduction	(360,000)
Less: State Income Taxes @ 10%	(100,000)
Federal Taxable IRA Value	$540,000
Federal Income Tax @ 40%	$216,000
Total IRA Value	$1,000,000
Less: Federal Estate Tax	(360,000)
Less: State Death Tax	(100,000)
Less: Federal Income Taxes	(216,000)
Less: State Income Taxes	(100,000)
Net IRA Value	$224,000
% of IRA Lost to Taxes	77.60%

Even if a client expects to be in the same income tax bracket in the future as she is today, it generally is better for the client to convert to a Roth IRA today and pay the income tax on the conversion. At first blush, this may not seem logical. However, when you factor in federal and state estate taxes, the reason for doing a Roth IRA conversion before death becomes evident.

Under general mathematical principles, it would first appear that doing a Roth IRA conversion prior to death would not have any impact on the client from an income tax perspective. This would be true if there was an income tax deduction for both the federal and state estate tax paid on a traditional IRA. Unfortunately, however, the Code Sec. 691(c) deduction applies only to the federal estate tax paid. Because of this, taxpayers in a state with an estate tax always lose a greater portion of a traditional IRA to tax than if they undertook a Roth conversion prior to death provided that the rate at conversion is close to or less than the marginal rate at distribution. Conversely, if there is a Roth conversion the client's estate would be allowed an estate tax deduction for all income taxes (both federal and state) paid prior to death. Accordingly, it is more tax efficient to incur an income tax before incurring an estate tax. Figure 10 illustrates this point.

Figure 10

	Traditional IRA	**Roth IRA**
Total IRA Balance	$1,000,000	$1,000,000

Less: State Income Tax on Roth Conversion @ 10%	–	(100,000)
Less: Federal Income Tax Paid on Roth Conversion @ 40% (tax imposed net of state death tax – i.e. on $900,000)	–	(360,000)
IRA Balance Subject to Estate Tax	$1,000,000	$540,000
State Estate Tax @ 10%	$100,000	$54,000
Federal Estate Tax @ 40% (tax imposed net of state death tax – i.e. on $900,000 & $486,000)	360,000	194,400
Total Estate Tax	$460,000	$248,400
Total IRA Balance	$1,000,000	–
Less: Code Sec. 691 (c) Deduction	(360,000)	–
IRA Balance Subject to Income Tax	$640,000	$0
State Income Tax at Distribution@ 10%	$64,000	$0
Federal Income Tax Paid at Distribution @ 40% (tax imposed net of state income tax – i.e. on $576,000)	230,400	0
Total Income Tax at Distribution	$294,400	$0
Total IRA Value	$1,000,000	$1,000,000
Less: Estate Tax	(460,000)	(248,400)
Less: Income Tax	(294,400)	(460,000)
Net IRA Value	$245,600	$291,600
Percent of IRA Lost to Tax	75.44%	70.84%

Roth IRA Segregation Conversion Strategy

A client who chooses to convert to a Roth IRA always has the option to eliminate the income tax liability associated with the conversion by "recharacterizing" (*i.e.,* undoing) the entire amount. If some of the assets have increased in value while others have decreased since the time of conversion, however, it would be more favorable to recharacterize only those assets that have experienced a loss. Unfortunately, the IRS anticipated this strategy and, in Notice 2000-39, promulgated the "anti–cherry-picking rules."

The anti–cherry-picking rules were designed specifically to prevent clients from recharacterizing only those Roth IRA assets that declined in value. The effect of these rules is to prorate all gains and losses over the entire Roth IRA instead of on an asset-by-asset basis, regardless of the specific asset recharacterized.

Example 7

On January 3, 2015, Roger converted $200,000 of his traditional IRA to a Roth IRA. At the time of conversion, the traditional IRA consisted of 50-percent Large-Cap Fund ($100,000) and 50-percent Mid-Cap Fund ($100,000). As of April 15, 2016, the Large-Cap Fund had declined in value to $75,000, while the Mid-Cap Fund had increased in value to $112,500. Thus, the total value of the Roth IRA account declined to $187,500. Should Roger choose not to recharacterize any of his Roth IRA conversion, he would have to pay income tax on the $200,000 conversion amount, even though the Roth IRA is currently only worth $187,500. This is shown in Figure 11.

Figure 11

	Value at Date of Conversion	Value at Date of Recharacterization	Increase/ Decrease in Value
Large-Cap Fund	$100,000	$75,000	(25,000)
Mid-Cap Fund	$100,000	$112,500	$12,500
Total	$200,000	$187,500	(12,500)

Accordingly, Roger would like to recharacterize all of Large-Cap Fund, but none of Mid-Cap Fund. Without the anti–cherry-picking rules, Roger could recharacterize the Large-Cap Fund and eliminate $100,000 of income tax liability (the value of Large- Cap Fund on the conversion date). However, these rules require that Roger prorate the gains and losses of the entire Roth IRA for purposes of determining the amount recharacterized.

In this case, in order to determine the amount recharacterized, Roger must first calculate the value of Large-Cap Fund as a percentage of the total value of the Roth IRA as of the recharacterization date. This percentage is 40 percent ($75,000/$187,500). Once the percentage has been determined, the value of the IRA, as of the date of conversion, is multiplied by the 40 percent figure. Thus, if Roger were to recharacterize the Large Cap Fund, he could reduce his taxable income by only $80,000 ($200,000 x 0.4) instead of by $100,000.

Notwithstanding the above, the anti–cherry-picking rules can be avoided by specifically identifying assets to be transferred to newly established Roth IRAs, one Roth IRA for each

grouping of assets. Typically, the grouping of assets would be a particular fund, stock or grouping of stocks within a market sector. Returns for different stocks, funds or market sectors could vary significantly. Some may decrease in value and others increase. Consequently, if the investment performance of one Roth IRA investment is poor, the client may recharacterize this "segregated" Roth IRA back to a traditional IRA to eliminate the ordinary income associated with that conversion, while allowing the other Roth IRAs to remain unchanged. The goal is to put different types of investments (*e.g.,* consumer goods, energy, communications, transportation, *etc.*) into "segregated" IRAs, convert each segregated IRA to a Roth IRA and thereafter re-characterize only those Roth IRAs that under-performed.

Example 8

Assume the same facts as presented in Example 7, except that instead of creating a single Roth IRA, Roger decides to create two separate Roth IRAs, one for the Large-Cap Fund ("Roth IRA #1") and one for the Mid-Cap Fund ("Roth IRA #2"). In this case, Roger would recharacterize Roth IRA #1 because the value of the Large-Cap Fund has gone down since the time of conversion. Provided that Roger recharacterized the entire amount held in Roth IRA #1, he will not owe any income tax on this conversion. Rather, Roger will only recognize ordinary income on the conversion to Roth IRA #2 ($100,000). Figure 12 shows the amount of Roth IRA conversion income that Roger would recognize in this example and in Example 7.

Figure 12

	Example 1	**Example 2**	**Difference**
Value on date of conversion	$200,000	$200,000	$ –
Value of Roth IRA at recharacterization	$187,500	$187,500	$ –
Ordinary income recognized	$120,000	$100,000	(20,000)
Ordinary Income tax @ 28%	$33,600	$28,000	(5,600)

By segregating the IRA into two separate Roth IRAs, under the above facts, Roger saves over $5,000 in tax!

What has been described above is commonly referred to as the "Roth IRA Segregation Conversion Strategy" and the steps for accomplishing this strategy are as follows:

1) Identify specific groups of assets and create new traditional IRAs for each asset "class."
2) Convert the separate traditional IRAs to separate Roth IRAs.
3) Extend the tax return and pay income tax on the total Roth IRA conversion.
4) Recharacterize specific underperforming Roth IRAs back to the traditional IRAs
5) File the extended income tax return reporting the Roth IRA conversions and recharacterizations.

The key to making this strategy work is to transfer assets expected to produce different returns into different IRAs. Assets with high correlation coefficients would be placed in the same IRA while assets with low or negative correlation coefficients would be placed into separate IRAs. This would give the taxpayer the best chance of segregating the gain assets from the loss assets.

Roth Conversion Timetable

- January 1, 2015: first date in which a 2015 Roth conversion may take place
- December 31, 2015: last date in which a 2015 Roth conversion may take place
- April 15, 2016: due date for the 2015 income tax return and the last date the tax liability on a 2015 conversion may be paid
- October 15, 2016: last date a recharacterization of a 2015 conversion may be made

Given the above timetable, the client is able to make a Roth IRA conversion decision early in 2015, wait to determine what effect the market may have on her Roth IRA and thereafter make a final recharacterization decision more than nine months after the year in which the conversion takes place. As a result, if executed properly, the client is afforded the opportunity to make a decision with "20/ 20 hindsight."

Determining the Proper Amount to Convert

Assume for a moment that the assets within a traditional IRA are only expected to grow at around five percent. In this situation, an "opportunistic conversion" is out of the question. Accordingly, the decision to convert now becomes more strategic and driven by long-term

economics. Given these assumptions, a conversion of the entire traditional IRA to a Roth IRA would be imprudent. In this case, the "optimum" conversion amount will be somewhere between a 100-percent conversion and no conversion at all.

The key to finding the "optimum" conversion amount will depend on the client's current and future projected income tax rates. As discussed earlier, to the extent that the client expects the future tax rate to be the same or higher than the current tax rate, little harm can be done by converting to a Roth IRA.

In many cases, the client will be in a higher income tax bracket in the future. The primary reason for this is that, upon reaching age 70 1/2, required minimum distributions (RMDs) must come from the traditional IRA. Depending on the size of the client's traditional IRA and the "other income" generated outside of the IRA (*e.g.*, taxable dividends and interest, Social Security, *etc.*), the client will most likely be in a higher tax bracket once RMDs begin. Thus, in choosing the "optimum" amount to convert to a Roth IRA, the client most likely would convert an amount which would be taxed at a rate that would be the same or less than the client's projected future tax rate.

<u>Example 9</u>

Linda, age 65 and married, has $100,000 in a traditional IRA which she may convert to a Roth IRA. Linda and her husband are in the 25-percent tax bracket, but expect to be in the 28-percent tax bracket once her RMDs begin. Assuming a brokerage account balance of $25,000 generating an after-tax growth rate of seven-percent and a pre-tax growth rate of eight-percent for the IRA, the amount of wealth Linda will have in the future is shown in Figure 13.

Figure 13

	Do Nothing			Roth IRA Conversion				
	Traditional IRA	Brokerage Account	Total	Roth IRA	Brokerage Account	Total	Difference ($)	Difference (%)
Pre-Tax Account Balance (Current)	$100,000	$25,000	$125,000	$100,000	$25,000	$125,000		
Less: Income Tax on Roth IRA Conversion @ 25%	$ –	$ –	$ –	$ –	(25,000)	(25,000)		
Less: "Built-In" Income Tax @ 28%	$28,000	$ –	$28,000	$ –	$ –	$ –		
After-Tax Account Balance (Current)	$72,000	$25,000	$97,000	$100,000	$ –	$100,000	$3,000	3.09%

Pre-Tax Account Balance (Year 10)	$215,892	$49,179	$265,071	$215,892	$ –	$215,892		
Less: "Built-In" Income Tax @ 28%	(60,450)	$ –	(60,450)	$ –	$ –	$ –		
After-Tax Account Balance (Year 10)	$155,443	$49,179	$204,621	$215,892	$ –	$215,892	$11,271	5.51%
Pre-Tax Account Balance (Year 20)	$466,096	$96,742	$562,838	$466,096	$ –	$466,096		
Less: "Built-In" Income Tax @ 28%	(130,507)	$ –	(130,507)	$ –	$ –	$ –		
After-Tax Account Balance (Year 20)	$335,589	$96,742	$432,331	$466,096	$ –	$466,096	$33,765	7.81%

IRA "Stretch-out" Considerations

Along with the above considerations, when determining whether or not to convert to a Roth IRA, one must consider that Roth IRAs are not subject to the RMD rules like traditional IRAs. The distributions the beneficiaries take from the Roth IRA will generally not be subject to income tax. Thus, depending on the size of the client's IRA, his life expectancy and the ages of the beneficiaries, the total amount of additional wealth that can be accumulated in a Roth IRA can be staggering.

Example 10

Mark, age 69 and single, is considering converting $100,000 to a Roth IRA. At the present time, Mark is in the 25-percent tax bracket and expects to be in the 25-percent tax bracket for the foreseeable future. In addition, Mark has named his son, Chris (age 42), as beneficiary of his traditional IRA. It is expected that Chris will also be in the 25-percent tax bracket when he inherits Mark's IRA.

The following are the other pertinent facts and assumptions:

Mark's assumed age at death	86
Taxable investment account	$25,000
Yield rate (*i.e.,* dividends and interest)	2.00%
Growth Rate	5.00%

Ordinary income tax rate	25.00%
Capital gains tax rate	15.00%

As evidenced by the chart in Figure 16, Chris would have over $80,000 more assets in 30 years if Mark were to convert $100,000 to a Roth IRA during the current year.

Using the same assumptions as above, except that the growth rate is seven percent instead of five percent, Chris would have over $150,000 more in 30 years if Mark were to convert $100,000 to a Roth IRA. This is shown in Figure 15.

Figure 14

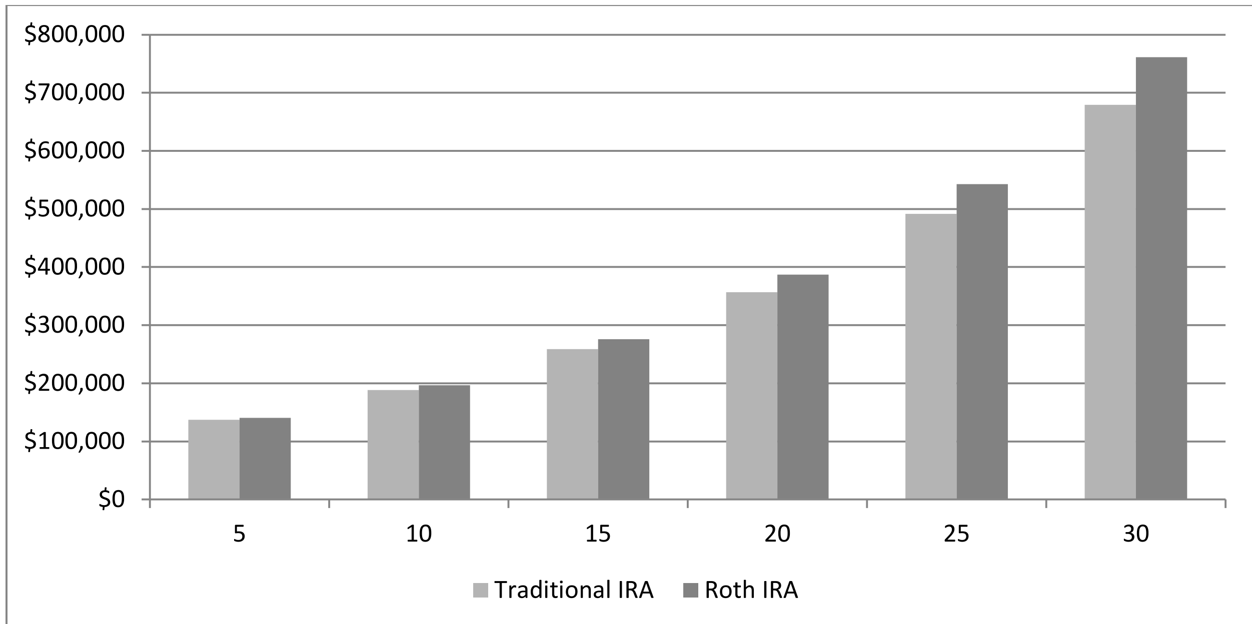
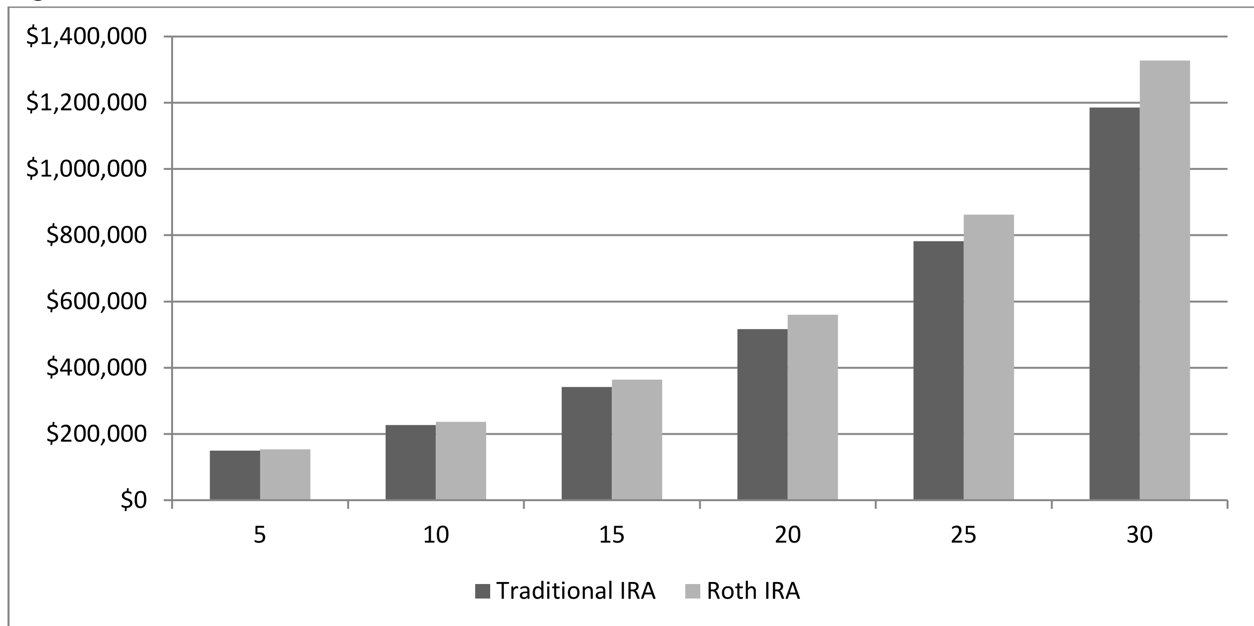


Figure 15



Conclusion

Roth IRA conversion planning, while complex, can provide significant value to clients. With a good understanding of the basic mathematical principles, one will be able to convey the quantitative advantages to clients.