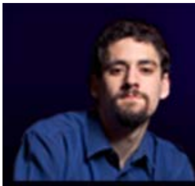

The Kitces Report

Advancing knowledge in financial planning... May 2009

To Roth or Not To Roth

For the past 12 years, clients have had the opportunity to contribute to a traditional or a Roth IRA. Both accounts present certain tax benefits that make them appealing in some situations, yet planners often fail to apply a clear analytical framework to determine which account type may be better to receive annual contributions in various situations.

In addition, an analytical framework for Roth versus traditional IRAs may apply not only in the context of making annual contributions, but also to the decision of whether or not to convert from a traditional to a Roth IRA. This aspect may be especially relevant in light of the expansion of eligibility for Roth conversions in 2010.

In this month's newsletter, we explore the necessary analytical framework to understand when and in what situations it may be more effective to contribute to a Roth IRA versus a traditional IRA and vice versa. By developing a series of rules and evaluating certain known exceptions to those rules, and also by exposing certain myths along the way, planners can more clearly evaluate when a Roth IRA contribution (or conversion) may or may not be effective for a particular client situation, to maximize long-term wealth accumulation.

About the Author

Michael E. Kitces, MSFS, MTAX, CFP®, CLU, ChFC, RHU, REBC, CASL, CWPP™, is the Director of Financial Planning for Pinnacle Advisory Group (www.pinnacleadvisory.com), a private wealth management firm located in Columbia, Maryland. In addition, he is an active writer and speaker, and publishes The Kitces Report and his blog "Nerd's Eye View" through his website www.kitces.com.

Background

With the Taxpayer Relief Act of 1997, Congress created the Roth IRA as a new alternative to the existing traditional IRA that had been around for nearly 25 years.

Prior to that point, tax-preferenced retirement savings only existed in one variety – the traditional IRA that allowed pre-tax contributions and tax-deferred growth, ultimately taxed as ordinary income but only at the time of withdrawal. With the introduction of the Roth IRA, though, taxpayers suddenly had a second choice – to make contributions with after-tax dollars and give up the tax deduction for contributions, in exchange for the opportunity to receive not only tax-deferred growth, but tax-free withdrawals of that growth for retirement purposes. And not only were investors presented with a choice about which account to contribute towards, but were also granted the opportunity to make a conversion from the pre-tax traditional IRA into the after-tax Roth IRA.

Unfortunately, with the choice to contribute to a traditional or Roth IRA (or convert from the former to the latter), investors must evaluate both options carefully to determine which will be more effective for long-term wealth accumulation. The breakeven point between them depends not only on tax rates, but several other factors as well. However, in order to understand which will be more effective for any individual client, it is first important to understand the existing technical tax rules that apply to both accounts.

Basic Rules

Traditional IRAs

The maximum IRA contribution limit (in 2009) is the lesser of the taxpayer's qualifying income, or $5,000. For those who will be age 50 or older as of December 31st, 2008, the $5,000 maximum is increased to $6,000. A taxpayer's qualifying income includes earned income

as an employee, self-employment income, or alimony. If the taxpayer does not have sufficient qualifying income, a spouse's income may be counted towards the qualifying earned income limit, as long as that portion of the spouse's earned income was not already utilized to count towards the spouse's own IRA contribution. However, a taxpayer must not yet reach age 70 ½ by the end of the tax year to be eligible to make an IRA contribution for that year.

Taxpayers who make a contribution within the maximum limits to a traditional IRA may be eligible for a tax deduction for the deposit. The deductibility of the contribution depends on the taxpayer's adjusted gross income (AGI), and the applicable AGI limits in turn depend on whether or not the taxpayer (or his/her spouse) is an active participant in an employer retirement plan.

Determining whether an individual is an active participant in an employer retirement plan depends slightly on the type of plan offered. (Of course, if no employer retirement plan is offered at all, the individual certainly will not be an active participant.) If the available plan is a defined benefit plan, the individual is deemed to be an active participant simply by being eligible to participate in the plan – even if the individual declines to participate, doesn't not accrue the minimum service required to participate, or otherwise fails to make any contributions to the plan. In the case of a 401(k) or 403(b) plan, an individual is an active participant if any salary deferral contributions are made to the plan (but only if contributions are actually made; mere eligibility to contribute does not trigger active participant status). Similarly, if the available plan is a profit-sharing plan or SEP IRA, the individual is deemed an active participant only if contributions are actually made to the plan; however, in this situation the individual is an active participant in the plan in the year that the contributions are actually deposited into the account, regardless of what year they are attributable to. In the case of a SIMPLE IRA or money-purchase plan, active participant status is triggered if any contributions are made to the account for the year to which the contributions are attributable; SIMPLE IRA active participant status is also triggered by any salary deferral contributions made. Notably, all of the above rules apply for the various plan types regardless of whether any contributions that accrue in a plan are vested or not.

If neither the taxpayer nor the taxpayer's spouse is an active participant (as defined by the rules above), the individual is eligible to make a deductible IRA contribution, regardless of income level. If the individual is an active participant, then the deductibility of the IRA contribution is phased out pro-rata as the taxpayer's modified AGI increased from $55,000 to $65,000 (or from $89,000 to $109,000 if married filing jointly). In the case of a taxpayer who is married filing jointly, if a spouse is an active participant when the individual is not an active participant, the phaseout level is increased to a range from $166,000 to $176,000. For purposes of this rule, modified AGI is the taxpayer's original AGI after adding back: any deduction for the IRA itself; the exclusions for savings bonds used to pay higher education and for employer adoption assistance; interest paid on qualified education loans; the above-the-line deduction for higher education expenses; any domestic production activities deduction; and the foreign earned income and housing cost exclusions for U.S. citizens living abroad. Even if an IRA contribution will not be tax deductible due to the taxpayer's income and active participant status, a non-deductible after-tax IRA contribution may be made regardless of how high his/her income is (as long as the minimum earned income requirements are met).

Withdrawals from an IRA are taxed as ordinary income, and may also be subject to an early withdrawal penalty of 10%. Withdrawals from an IRA are *not* subject to the early withdrawal penalty if they are:

- Made after the taxpayer turns age 59 ½;
- Distributed to a beneficiary after the death of the IRA owner;
- Rolled over to another retirement account within 60 days (as long as all elements of the 60-day rule are complied with);
- Taken when you are permanently or totally disabled;
- Taken when you were unemployed if used to pay health insurance premiums;
- Used to pay for college expenses for yourself, a spouse, or a dependent;
- Used according to the first-time homebuyer special exception;
- Used to pay for medical expenses that exceeded 7.5% of your AGI;
- Used to pay off an IRS levy against your retirement account; or
- Are part of a series of substantially equal periodic payments (in compliance with the associated rules).

If any traditional IRA account includes any non-deductible after-tax contributions, then the return of such contributions are received tax-free when withdrawn from the IRA. However, to the extent there are any after-tax contributions in any IRA accounts, all IRA accounts must be aggregated for tax purposes and

any withdrawal is treated as a pro-rata withdrawal of pre- and after-tax amounts. Thus for example, if a taxpayer has a $100,000 IRA with $5,000 of after-tax contributions and also has a $400,000 IRA (a total of $500,000 in IRAs), then any withdrawal will be treated as $5,000 / $500,000 = 1% after-tax, and the other 99% of any withdrawal will be treated as taxable. Notably, this ratio applies regardless of what account the funds are withdrawn from, and applies regardless of whether the pre-tax amounts are attributable to pre-tax contributions, growth on pre-tax contributions, or growth on after-tax contributions.

Once a taxpayer reaches age 70 ½, so-called Required Minimum Distributions (RMDs) must begin from the IRA account in accordance with the associated rules and IRS tables.

Roth IRAs

Although Roth IRAs have the same maximum contribution amount ($5,000 in 2009, plus a $1,000 catch-up contribution if age-eligible, assuming the individual has sufficient qualifying earned income and following the same spousal income rules), the eligibility to contribute in the first place may be restricted based on the taxpayer's modified AGI. Thus, the maximum eligible contribution amount for a Roth IRA is phased out as modified AGI increases from $105,000 to $120,000 for single taxpayers (from $166,000 to $176,000 for married joint filers) for 2009. (Modified AGI for these purposes is defined in the same manner as discussed earlier, but also excludes any income due to a Roth conversion, or due to a required minimum distribution received from a traditional IRA.) If the taxpayer's income is high enough, the maximum contribution amount to a Roth IRA can be reduced from $5,000 all the way down to a "maximum" contribution of $0, rendering the individual ineligible to make a Roth contribution. Notably, any contributions to a traditional IRA also reduce the maximum contribution amount to a Roth IRA (to prevent taxpayers from "double-dipping" both contribution limits); thus, for example, an individual who contributes $3,000 to a traditional IRA may only make another $2,000 of contributions to any other IRA, traditional or Roth, to avoid exceeding the $5,000 total contribution limit (before including catch-up contributions).

Contributions to a Roth IRA do not create any kind of tax deduction. However, growth in a Roth IRA is still tax-deferred, and withdrawals from the Roth IRA may be tax-free under one of several provisions. First of all, to the extent that after-tax contributions have been made to a Roth IRA, the original contributions may be withdrawn at any time, free of any income taxes or penalties. Any withdrawals from a Roth IRA are automatically deemed to first come from after-tax Roth contributions (unlike the pro-rata rule that applies to withdrawing non-deductible contributions from a traditional IRA), and thus may be extracted tax-free at any time (although putting the funds back into the account, aside from via a timely rollover, will again be subject to the normal contribution limitations). To the extent that all original after-tax contributions have been withdrawn, any subsequent distributions are treated as coming from growth in the IRA (unless Roth conversions have occurred, as discussed further later). Withdrawals of growth may be tax-free, beginning on the first day of the fifth year after the year the Roth IRA was established (the so-called "5 year rule"), as long as the taxpayer is *also* either over age 59 ½ or the distribution is after the death of the Roth IRA owner, due to a permanent or total disability of the Roth IRA owner, or is eligible for special first-time homebuyer treatment. To the extent a withdrawal of earnings does not satisfy the 5-year rule *and* one of the subsequent requirements (age 59 ½, death, disability, or first-time homebuyer), it will be subject to ordinary income taxes. Separately, a withdrawal of earnings (but not original contributions) from a Roth IRA is also subject to a 10% early withdrawal penalty in the same manner as the traditional IRA, unless one of the early withdrawal exceptions applies. Notably, the 10% early withdrawal penalty can apply regardless of whether the earnings withdrawal was eligible for tax-free treatment or not (as the early-withdrawal and tax-free-earnings requirements are similar, but not all of the exceptions/requirements are the same).

Out and About

- Michael will be presenting "Safe Withdrawal Rates: Mechanics, Uses, and Caveats" at FPA Illinois Annual Symposium in Oakbrook, IL, on June 8th

- Michael will also be presenting an "Income Tax Planning Update" at the WealthCounsel "Planning for the Generations" Conference on August 6th

- Michael will be speaking on income tax and retirement income planning topics at the Garrett Planning Network Retreat conference on August 7th

Interested in booking Michael for your own conference or live training event? Contact him directly at ***speaking@kitces.com***, or see his list of available presentations at www.kitces.com/presentations.php.

Unlike traditional IRAs, the Roth IRA has no requirement to begin distributions while the IRA owner is alive. However, both traditional and Roth IRAs follow the same required minimum distributions for beneficiaries after the death of the original IRA owner (although the post-death Roth IRA distributions may still be eligible for tax-free treatment).

Roth IRA Conversions

In addition to making Roth contributions directly, taxpayers can also increase the amount of their Roth IRA funds by completing a conversion of a traditional IRA to a Roth IRA. Technically, a Roth IRA conversion is simply a rollover from a traditional IRA to a Roth IRA, but has additional tax consequences associated with it. Converting IRA funds from traditional to Roth IRA status requires the taxpayer to report all pre-tax amounts as ordinary income for tax purposes (although any conversion amounts attributable to after-tax IRA contributions is not taxed, and after-tax amounts are determined under the same pro-rata rules applicable to any traditional IRA distribution). If only a portion of the IRA account is converted, only that portion is reported as a conversion for tax purposes (i.e., Roth conversions can be partial or full amounts of the total account). As long as the conversion is completed in a timely manner, no premature withdrawal penalties will apply to a Roth conversion transaction.

As a special rule for the year 2010 only, if amounts are converted to a Roth IRA during the calendar year, the conversion amount can be reported evenly in income in 2011 and 2012, instead of being reported as normal in 2010. Taxpayers may choose to elect out of this treatment (and report the full conversion in 2010) if desired. Otherwise, income will be spread evenly in the subsequent two years; thus, for example, if $100,000 is converted in 2010, the taxpayer would report $50,000 in income in 2011, and the other $50,000 in 2012, creating whatever tax liability applies when additional income is incurred in that year.

In order to be eligible to complete a Roth conversion, the taxpayer must have a modified Adjusted Gross Income of less than $100,000 (determined the same as modified AGI in the preceding discussion regarding contributions). The threshold is the same for both single tax filers, and a married couple filing jointly. Beginning in 2010, the income limits for Roth conversions are removed, allowing any taxpayer to complete a Roth conversion regardless of income. Any Roth conversion distribution must occur by the end of the year (December 31st) to be eligible for a conversion in that tax year, although notably the conversion funds can be deposited to the recipient Roth IRA after the end of the year (as long as the conversion distribution otherwise complies with the timeline requirements for a rollover).

A Roth conversion transaction can be reversed under the Roth recharacterization rules. The recharacterization rules allow you to transfer any assets that were converted from an IRA to a Roth IRA back to an IRA again. The recharacterization rollover back to the traditional IRA must occur by the due date of the tax return for the tax year in question, including extensions. Thus, for example, the recharacterization of a 2009 Roth conversion can be completed by April 15, 2010, or later if an extension is filed. Any amounts that are rolled back via a recharacterization must be adjusted for any gains or losses that occurred during the intervening time period. To the extent that the recharacterization is completed in a timely manner, it is as though the Roth conversion had never occurred, and thus no Roth conversion income is reported for tax purposes.

Distribution rules from Roth IRAs are altered slightly when the account includes amounts that are attributable to a Roth conversion. Consequently, although the general rule is that any after-tax contribution amounts can be withdrawn from a Roth IRA tax-free and penalty, the "after-tax" amounts contributed via a Roth conversion (since tax was paid at the time of conversion) are not quite so freely available. Instead, the tax code stipulates that a withdrawal of an amount that was attributable to a Roth conversion may be subject to the 10% early withdrawal penalty if it is taken out within 5 years of the conversion (or more specifically, before the first day of the fifth taxable year after the conversion). If an exception to the early withdrawal penalty otherwise applies already, the amount will not be subject to the penalty regardless of the 5-year time period. However, if not otherwise eligible for an exception, this special 5-year rule applies. Each Roth conversion amount will have its own 5-year period for the purpose of this rule (and these 5-year periods are separate from the requirement that a Roth IRA be established for 5 years to be eligible for tax-free withdrawals of earnings). To the extent that there are contributions in a Roth IRA attributable to both regular Roth IRA contributions, and a Roth conversion, the amounts are treated as first coming from the Roth IRA contributions (tax- and penalty-free), then from Roth conversions (tax-free but requiring a separate 5-year rule before being penalty free), and then from any Roth earnings/growth (tax-free only if the separate requirements are met for withdrawing tax-free Roth

IRA earnings). If there are several Roth conversion contributions, withdrawals are deemed to come from the earliest Roth conversion first.

The Roth vs. Traditional IRA Comparison

The Tax-Equivalency Principle

To evaluate the relative value of contributing to a Roth or traditional IRA, it is important to compare from an equivalent starting point. Consequently, to simply compare a $5,000 traditional IRA to a $5,000 Roth IRA yields an apples-to-oranges result, because one account provided a tax deduction upon creation while the other did not, which means they required a different amount of pre-tax income to make the same contribution.

A more effective framework is to compare a similar amount of pre-tax income, and towards what account to allocate it. Thus, for example, if an individual earns $5,000 of income that is available to save, it can be contributed towards a $5,000 traditional IRA (yielding no further tax consequences because the deduction for a $5,000 contribution offsets the $5,000 of initial earned income), or towards a $3,750 Roth IRA (assuming the individual pays 25% income taxes on the earned income and contributes the remainder).

At first glance, it may appear that the individual who ends out with a $5,000 traditional IRA is wealthier than the one with a $3,750 Roth IRA (since $5,000 is greater than $3,750), but the comparison cannot end here. Instead, to make an accurate comparison of wealth, we must ultimately determine the amounts that the taxpayer would have available to spend after liquidating the IRAs (since you cannot directly spend money from an IRA without tax consequences).

Let's assume that the IRA funds are held for a period of years, sufficient to earn 100% returns that double the value of each account (and since they are invested identically, they would be assumed to each grow the same percentage on their initial investment contribution). As a result, at the end of the time period the traditional IRA has grown to $10,000, and the Roth IRA has grown to $7,500. If the Roth IRA meets the appropriate requirements, it can be consumed without taxation through tax-free withdrawals of principle and earnings - which means the $7,500 account balance actually represents $7,500 of spendable dollars. For the traditional IRA, on the other hand, the $10,000 cannot be spent without ultimately facing tax consequences. Assuming there has been no change in tax rates, the traditional IRA will ultimately be reduced by 25% for taxes, resulting in $10,000 - $2,500 (taxes) = $7,500 of spendable dollars.

Notably, this means the two accounts yield the exact same result, with $7,500 of spendable dollars at the end of the time period. In point of fact, this mathematical truth holds regardless of whether the dollars are taken out in a lump sum at the end, or over time, and it equally applies regardless of the growth rate or the time period. In other words, when tax rates remain the same, the fundamental decision to direct a certain amount of pre-tax income towards either a traditional or Roth IRA will result in the exact same amount of final spendable after-tax dollars. This is because, mathematically, the present value of a traditional IRA's tax liability is always exactly the same (since the growth rate is the same as the discount rate); thus, it doesn't matter how long the IRA grows, or what it grows to – in our current example, the present value of the IRA is always $10,000, the present value of the tax liability is always $2,500, and the present value of the net amount is always $7,500, the same as the Roth IRA value, as long as the tax rate doesn't change. This can be seen graphically in figure 1 to the left, which shows the accumulated value of the $10,000 IRA (green area) and negative tax liability (red area, assuming a 25% tax rate), and the net value of the IRA after the tax

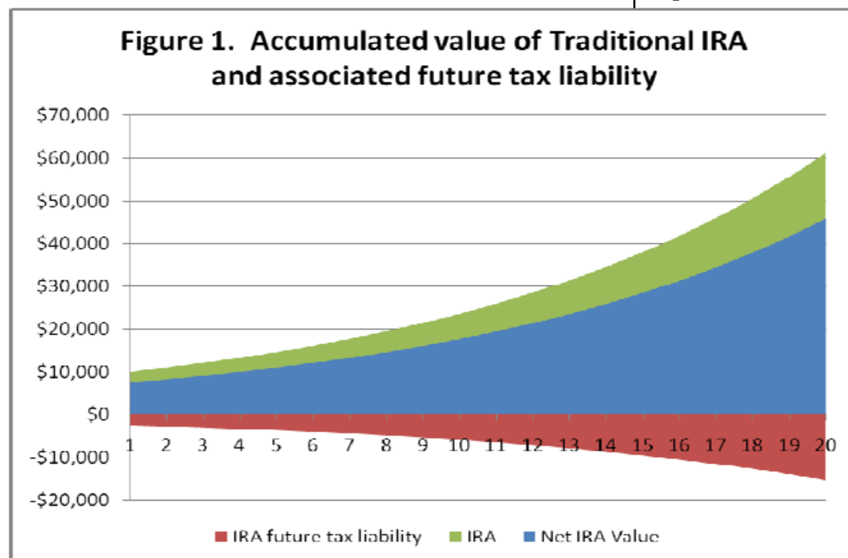

Figure 2. Illustration of Roth versus Traditional IRA with varying tax rates.

Year	Roth @ 25%	IRA @ 15%	IRA @ 20%	IRA @ 25%	IRA @ 30%	IRA @ 35%
1	$7,500	$8,500	$8,000	$7,500	$7,000	$6,500
2	$8,250	$9,350	$8,800	$8,250	$7,700	$7,150
3	$9,075	$10,285	$9,680	$9,075	$8,470	$7,865
5	$10,981	$12,445	$11,713	$10,981	$10,249	$9,517
10	$17,685	$20,043	$18,864	$17,685	$16,506	$15,327
15	$28,481	$32,279	$30,380	$28,481	$26,582	$24,684
20	$45,869	$51,985	$48,927	$45,869	$42,811	$39,753
30	$118,973	$134,836	$126,905	$118,973	$111,042	$103,110
40	$308,586	$349,731	$329,158	$308,586	$288,013	$267,441

liability (blue area). Notably, at any point on the graph, the value of the blue area (net value of the IRA) is exactly the same as the value of a $7,500 Roth IRA growing at the same rate (10% in the graph below). This in turn leads to the first rule of the traditional vs. Roth IRAs: **Rule #1 - As long as the tax rate does not change during the time period, the tax-equivalency principle holds true**.

On the other hand, when there is a change in tax rates, the tax-equivalency principle no longer holds. Once a change in tax rates occur, the future tax liability associated with a traditional IRA shifts, and the present value of that tax liability may be higher or lower than the taxes that must be paid to contribute to a Roth IRA in the first place. Thus, when tax rates change between the time of contribution and the time of withdrawal, you should choose a Roth IRA if your tax rates are lower now and will be higher in the future, and you should choose a traditional IRA if your tax rates are higher now and will be lower in the future. In both cases, you aim to pay your tax liability whenever the tax rate is lower. Notably, this means it can be good to defer your tax liability with a traditional IRA, even if it means the *total* amount of taxes you pay may be much larger in the future (because the account will be larger); as long as the overall tax rate that applies to the future distribution is lower (and doesn't change due to the size of the distribution itself), the present value of the tax liability will be lower, and it will be more efficient for wealth accumulation to defer taxes. This result is shown in figure 2 above, which provides an example of a $10,000 Roth IRA contribution facing a 25% current tax rate, versus a $10,000 traditional IRA contribution that faces tax rates varying from 15% to 35% at some point in the future (assuming a 10% growth rate all along). Note that in the column where the IRA is taxed in the future at 15%, the taxpayer will ultimately pay $61,717 in taxes on a $411,448 gross account balance to finish with $349,731, instead of paying only $2,500 in taxes to contribute to a Roth IRA in year 1; nonetheless, because the tax *rate* is lower in the future, total accumulated after-tax wealth is significantly higher even though the sheer amount of dollars paid in taxes for the traditional IRA in the future is larger. These results lead to the next rule of the traditional vs. Roth IRA comparison: **Rule #2 - If tax rates will change, pay your tax liability whenever the tax *rate* will be lower.**

It is important to note that because of Rule #2, it is always beneficial to contribute to a Roth IRA if tax rates are lower now (and will be higher later), and is always beneficial to contribute to a traditional IRA if tax rates are higher now (and will be lower later). This principle holds true regardless of what the current account balance is, and regardless of how quickly the account grows or how long it will be held. Instead, the growth rate and the time period of deferral will *magnify* the results of a change in tax rates, but they cannot *reverse* the results. In other words, if the tax rate change is favorable, a longer time period and/or a higher growth rate create even *more* wealth; if the tax rate change is unfavorable, a longer time period and/or a higher growth rate make the unfavorable result even worse. But a favorable growth rate or a longer time period cannot change the fact that a lower current tax rate always favors the Roth, and a higher current tax rate favors the traditional IRA. This can be seen by looking back at Figure 2, where the first line of the chart (for Year #1) in essence reflects the after-tax present value of the IRA account. In this example, whether the account grows at 6%, 8%, 10%, or 20% per year, when it is discounted back to the present value (at the same time) the traditional IRA will always be ahead or behind by the same amount. The growth rate simply affects the magnitude of how much more, or less, the client will have as the tax rate differential grows over time.

However, there are a few important exceptions that do apply to the general rules #1 and #2, which will now be discussed further.

Exceptions To The Rules

There are a few important factors that cause rules #1 and #2 to not hold true in all cases, and which may cause a Roth IRA to be favored over a traditional IRA even if tax rates may be slightly lower in the future. They are:
- Required Minimum Distributions
- Paying taxes with outside dollars
- Estate taxes

Required Minimum Distributions

The fact that Required Minimum Distributions (RMDs) exist for traditional IRAs but not Roth IRAs represents the first exception to rules #1 and #2. The reasoning is simple: to the extent that both accounts remain intact and the savings are growing tax-advantaged, the effectiveness of using one versus the other is driven by tax rates, but the RMD rules don't allow the traditional IRA to remain intact. Instead, the application of RMDs to the traditional IRA forces money out of the tax-favored environment, and into a regular taxable account where it will grow less efficiently due to ongoing taxation. In addition, the account will lose the opportunity to earn growth on the amount of RMD taxes that must be paid – although notably, as discussed earlier, the traditional IRA withdrawal itself must eventually be taxed at some point anyway if it is ever to be spent, so the lost value is only the *growth on* the taxes paid for the RMD, not the total amount of taxes paid. Nonetheless, the RMD amount represents both a portion of lost growth (on the amount of taxes paid), and the portion of the traditional IRA that is forced out of IRA status does grow less tax-efficiently in the future (since it no longer enjoys the tax-deferral of the IRA). These consequences of the RMD result in the traditional IRA being a slightly less effective growth vehicle over time. Notably, the loss of growth on the amount of taxes paid on the IRA's RMD is similar to the loss of growth on taxes paid when amounts are contributed to a Roth IRA; the difference is that in the case of the Roth, this represents a trade-off for tax-free growth, while with an RMD in to a taxable account it simply results in less-tax-efficient growth.

Because the only adverse impacts of an RMD are the loss of growth on the RMD taxes paid (but not the whole RMD amount) and the *subsequent* less-tax-efficient growth, a single RMD in any particular year is not especially damaging to long-term wealth accumulation. Only through multiple years does the cumulative impact of RMDs become significant, due to both taxation eroding the RMD amounts outside of an IRA and the accumulating amount of total RMDs forced out of the IRA and reduced by taxation. Nonetheless, as a result of RMDs, one indirect benefit of a Roth contribution or conversion is the opportunity to maintain the account intact for a longer period of time. To measure the impact of the reduced tax efficiency due to RMDs, Figure 3 at the top of the next page shows how much lower tax rates could be in the future, and still come out ahead rather than completing a Roth conversion at a current tax rate of 25%. Note that this in essence represents a violation of rules #1 and #2 – in this case, tax rates can actually be lower in the future, and the Roth transaction is still favored. The projections below assume a generic 60% equities and 40% fixed portfolio that is rebalanced annually and has 40% turnover, where stocks earn a 3% dividend and 7% growth (10% total return) and the fixed portfolio earns 5%, and where qualified dividends and capital gains are taxed at 15% and ordinary income/interest is taxed at 25%.The columns on the far right indicate the breakeven future ordinary income tax rate on IRA withdrawals that would cause the Roth IRA (or rather, a Roth conversion) to still be more tax-favored, and the wealth gained column shows the amount of additional wealth accumulated via a Roth IRA if there is no change in future tax rates.

Notably, the results reveal that the tax rate differential for avoiding RMDs is still only a few percentage points over time, and there is very little material difference in wealth for many years. For the first 15 years, the tax-equivalency rule still nearly holds true – a slight drop in future tax rates may still favor the Roth IRA, but any greater drop in future tax rates will favor the traditional IRA notwithstanding the RMDs. Only when the individual reaches further into their late 80s and begins their 90s does the loss of compounding impact of the RMD begin to accumulate to material amounts, to the extent that the Roth IRA will come out ahead unless future tax rates drop much more significantly.

Paying Taxes with Outside Dollars

As we explored earlier, to compare a Roth account to a traditional account requires starting with the same amount of pre-tax income, and then either tracing its contribution to a traditional account, or to a Roth account where the individual must also use a portion of the income to pay taxes and may only use the remainder for a Roth contribution. In the generic example with $5,000 of pre-tax income, this is a relatively straightforward approach, resulting in a $5,000

Figure 3. Impact of avoiding RMDs via a Roth conversion at various future ages.

Age	IRA	RMD	Taxable Account (EOY)	IRA (EOY)	After-Tax Net Worth (EOY)	Roth IRA equivalent	Breakeven Future Tax Rate	Wealth Gained
70	$100,000	$3,650	$2,928	$104,058	$80,962	$81,000	24.96%	$38
71	$104,058	$3,927	$6,279	$108,142	$87,357	$87,480	24.89%	$123
72	$108,142	$4,224	$10,095	$112,231	$94,216	$94,478	24.79%	$263
73	$112,231	$4,544	$14,424	$116,303	$101,568	$102,037	24.66%	$468
74	$116,303	$4,887	$19,318	$120,329	$109,447	$110,200	24.49%	$753
75	$120,329	$5,255	$24,835	$124,281	$117,887	$119,016	24.29%	$1,129
76	$124,281	$5,649	$31,037	$128,122	$126,923	$128,537	24.06%	$1,614
78	$131,845	$6,495	$45,727	$135,378	$146,944	$149,925	23.51%	$2,981
80	$138,710	$7,418	$63,953	$141,796	$169,844	$174,873	22.85%	$5,029
82	$144,584	$8,455	$86,363	$147,020	$195,999	$203,972	22.08%	$7,973
84	$149,040	$9,615	$113,732	$150,578	$225,826	$237,913	21.21%	$12,087
86	$151,637	$10,754	$146,775	$152,153	$259,792	$277,501	20.25%	$17,710
88	$152,062	$11,973	$186,358	$151,296	$298,422	$323,678	19.20%	$25,255
90	$149,783	$13,139	$233,401	$147,575	$342,305	$377,538	18.08%	$35,233
92	$144,624	$14,179	$288,660	$140,881	$392,105	$440,360	16.90%	$48,255
94	$136,302	$14,978	$353,031	$131,030	$448,576	$513,636	15.67%	$65,060

traditional IRA contribution of a $3,750 Roth IRA contribution (assuming a 25% tax rate).

However, the situation changes slightly when an individual seeks to make a maximum contribution to a Roth account (or, similarly, to complete a Roth conversion). For example, if an individual wishes to contribute the maximum $5,000 amount to a Roth IRA, the requisite pre-tax income is actually $6,667. In this case, though, the pure tax-equivalency principle cannot be applied, because $6,667 would exceed the maximum traditional IRA contribution limits. Thus, for the individual who has $6,667 of available pre-tax income, the contribution choices become $5,000 to a Roth IRA, or $5,000 to a traditional IRA with approximately $1,250 remaining in a taxable side account (which is the excess $1,667 after 25% taxes are paid). As was seen in the discussion regarding RMDs, though, a traditional IRA with a side account will not grow as effectively as a Roth IRA over time, because the same amount of pre-tax income ($6,667) is not growing fully tax-deferred in both cases.

Thus, to the extent that an individual wishes to make a contribution to a Roth IRA that requires pre-tax income greater than what could be contributed to a traditional IRA, a natural benefit emerges to favor the Roth IRA. And in point of fact, as long as the maximum traditional IRA and Roth IRA limits are the same, this result will always occur, because the Roth IRA can utilize a larger amount of pre-tax income for the same maximum annual contribution.

As with the RMD, the magnitude of the benefit can be measured by evaluating how much lower tax rates could be in the future on IRA withdrawals, and still favor the Roth IRA (in contrast to the normal application of rule #2 that would suggest lower tax rates in the future favor the traditional IRA). These results are shown in Figure 4 on the next page. As with the prior chart, the columns on the right show the breakeven future tax rate (as long as the future tax rate is at the breakeven or higher, the Roth IRA will be favored, even if it is a tax rate slightly lower than the current 25%), and the amount of wealth gained in favor of the Roth account assuming there is no change in tax rates. The chart assumes there is $6,667 of pre-tax income available for contribution, and uses the same tax and growth assumptions as the prior analysis for RMDs.

Notably, the results reveal that it still takes a significant period of time before the Roth IRA results in a material benefit. Even after 15 years, the benefit of the Roth IRA is lost if the tax rate applicable to traditional IRA withdrawals drops more than 5%. However, for those

who are accumulating at a younger age, and/or who will not need to spend the IRA for an extended period of years, a significant benefit can accumulate over the span of 40-50+ years in the form of a Roth account that is favored even if tax rates drop as much as almost 9% (from 25% down to 16.18%). It is important to bear in mind when viewing the wealth gained column, though, that a significant portion of the wealth gained is simply due to the compounding of growth over time. For instance, after 50 years, the wealth gained is $37,550 by selecting a Roth IRA when the tax rates don't change, from a scenario that only started out with $5,000 of after-tax spendable wealth! However, on a present value basis, the $37,550 wealth gained represents an increase of wealth of only approximately $800, which means overall wealth was really enhanced by only about 16% over the span of 50 years ($800 out of the original $5,000 of after-tax dollars available).

A similar result occurs any time an individual is evaluating the conversion of a traditional IRA to a Roth IRA. When a conversion is considered, the maximum amount that can be contributed to the Roth conversion account is the same as the account balance in the traditional IRA (i.e., you can convert up to 100% of the account); consequently, the same result emerges as existed with the traditional versus Roth contributory decision. For a given dollar amount – such as a $250,000 account – the individual can accrue a traditional IRA, or liquidate a less-tax-efficient side account of $62,500 (assuming a 25% tax rate) for the opportunity to own a $250,000 Roth IRA. Over time, the $250,000 Roth IRA will accrue greater wealth than the $250,000 pre-tax account with a $62,500 taxable side account, in the same manner that a $5,000 contributory Roth IRA accrues more wealth than a $5,000 pre-tax IRA with a $1,250 side account. As with the contributory example, the magnitude of the benefit (how much tax rates can drop in the future and yet still favor the Roth account, and how much wealth is gained if tax rates do not change) increases given more years to accumulate and less tax efficient assumptions for the side account.

Thus, as long as there is a Roth versus traditional decision where the maximum amount that can be contributed to both accounts is the same, the Roth IRA is favored when tax rates remain the same and all else is equal. In essence, this occurs because the traditional IRA limit includes both a portion of the account that grows tax deferred, and a portion of the account that is "held" as a future tax liability; on the other hand, the Roth IRA represents a fully-tax-deferred account, without crowding out a portion of its account size or contribution limits to include a future tax liability.

In a generalized manner, this exception applies any time an individual is considering a Roth IRA contribution (or conversion) where the pre-tax equivalent amount would exceed the corresponding IRA limit, effectively allowing someone to *avoid the embedded tax liability of the IRA limits*. For instance, if the individual wishes to contribute $5,000 to a Roth IRA (the maximum limit), the exception will apply because $6,667 cannot be contributed to a traditional IRA. On the other hand, if

Figure 4. Impact of IRA contribution limit vs a Roth IRA over time with $6,667 of pre-tax income.

Year	Roth IRA	Traditional IRA	Taxable Account (EOY)	Roth IRA (EOY)	IRA After-Tax Net Worth (EOY)	Breakeven Future Tax Rate	Wealth Gained
1	$5,000	$5,000	$1,250	$5,400	$5,382	24.68%	$17
2	$5,400	$5,400	$1,424	$5,832	$5,790	24.31%	$42
3	$5,832	$5,832	$1,511	$6,299	$6,225	23.92%	$73
4	$6,299	$6,299	$1,602	$6,802	$6,692	23.53%	$110
5	$6,802	$6,802	$1,697	$7,347	$7,194	23.15%	$153
10	$9,995	$9,995	$2,250	$10,795	$10,327	21.55%	$467
15	$14,686	$14,686	$2,979	$15,861	$14,850	20.32%	$1,011
20	$21,579	$21,579	$3,944	$23,305	$21,391	19.35%	$1,914
25	$31,706	$31,706	$5,223	$34,242	$30,862	18.57%	$3,381
30	$46,586	$46,586	$6,915	$50,313	$44,593	17.92%	$5,720
40	$100,576	$100,576	$12,122	$108,623	$93,490	16.92%	$15,133
50	$217,137	$217,137	$21,251	$234,508	$196,958	16.18%	$37,550

the individual only wished to contribute $3,000 to an IRA, the tax-equivalency rule #1 will still apply, because the individual could choose to make a full $4,000 pre-tax IRA contribution, and the traditional and Roth IRA would have the same after-tax wealth value if there is no change in tax rates (aside from the impact of RMDs).

Estate Taxes

Estate taxes represent another potential exception to the tax equivalency rule, although contrary to popular belief the benefit generally only exists to reduce the impact of *state* estate taxes, not Federal estate taxes. The basic strategy, typically implemented as a Roth conversion, would normally be applied as follows:

> John Smith has a $2,000,000 IRA, and when added to his $4,000,000 of taxable accounts has a $6,000,000 total estate. Because he exceeds the $3.5 million Federal estate tax exemption, his estate will be subject to estate taxes on the $2.5 million excess. However, if John completes a Roth conversion, he will have a $2,000,000 Roth IRA and must pay a $600,000 tax liability (assuming a 30% tax rate). This reduces his taxable account to $3,400,000, and his total estate to $5,400,000. Thus, even if there is no change in future tax rates (i.e., the tax equivalency rule still holds), John will still provide more wealth for his beneficiaries because his estate will only face estate taxes on $1,900,000 (the excess of $5.6M over the $3.5M exemption), instead of paying estate taxes on $2,500,000. At a 45% estate tax rate, this results in $270,000 additional wealth to John's heirs by having a taxable estate that is $600,000 smaller.

The problem with the example above is that it ignores an important part of the tax code - the so-called "IRD" deduction for Income in Respect of a Decedent. The IRD deduction provides an *income* tax deduction to future beneficiaries, for any estate taxes paid that were attributable to pre-tax assets held in a decedent's account – such as estate taxes paid on an IRA.

In John's case above, when John's beneficiaries inherit a $2,000,000 pre-tax IRA that had $900,000 of estate taxes associated with the IRA (assuming the same 45% estate tax rate), then the beneficiaries will be eligible for a future $900,000 income tax deduction. Consequently, the beneficiaries will only be required to pay income taxes on $1,100,000 of the remaining IRA. This results in the exact same amount of final wealth to the beneficiaries, as shown in Figure 5 below.

Thus, as long as the IRD deduction will be available for the pre-tax IRA, a Roth conversion does not actually produce any Federal estate tax savings. Although some future wealth may be created simply by converting to a $2,000,000 Roth IRA and reducing the amount of tax-inefficient "side account" assets, this potential benefit can and should be evaluated independently – it is an income tax benefit of the Roth conversion, and not an estate tax benefit.

However, the results are different if the individual is also subject to *state* estate taxes, for the simple reason that the IRD deduction is based on Federal estate taxes and it typically not available at the state level for state estate taxes that are paid. As a result, although the Roth

Figure 5. Illustration of zero-impact Roth conversion on estate taxes.

	Traditional IRA scenario		Roth conversion scenario	
	Traditional IRA	Other Assets	Roth IRA	Other Assets
Gross value	$2,000,000	$4,000,000	$2,000,000	$3,400,000
Total estate		$6,000,000		$5,400,000
Estate tax @ 45% over $3.5M		$1,125,000		$855,000
Net estate		$4,875,000		$4,545,000
IRD deduction	$900,000		$0	
Amount of IRA taxable	$1,100,000		$0	
Remaining income tax		$330,000		$0
Net after-tax value		**$4,545,000**		**$4,545,000**

conversion strategy does not reduce the final total tax liability of an estate for the benefit of Federal estate taxes, it may still provide an estate tax savings at the state level. Notably, though, this benefit must be evaluated on a state by state basis, as it depends on both the individual having a large enough estate to be subject to state estate taxes, and a state estate tax system that does not allow an IRD deduction from the state for estate taxes paid to the state. Nonetheless, in many states, the above scenario would in fact render a favorable result, where the total income and *state* estate taxes on a $5.4 million estate with a Roth IRA really are lower than on a $6 million estate including a $2 million pre-tax IRA.

Aside from the opportunity for state estate tax savings, there is one other situation where a Roth conversion may still yield estate tax savings and do so at the Federal estate tax level. Let us look at another version of the prior example, except in this case we will assume that the IRA is $4,000,000, and the other taxable assets are only $2,000,000 (the reverse of the original scenario); in this case, the total estate is still $6,000,000, but we have changed the composition of the estate to make the IRA a larger portion of the total assets. The income and estate tax implications of this account structuring are shown in Figure 6 below.

In this situation, the net after-tax value of the two scenarios is no longer the same; the Roth conversion scenario results in a higher net after-tax value for the family. But what accounts for the difference? Why is the impact of a Roth conversion material with the $4,000,000 IRA and $2,000,000 taxable account, but not the other way around?

The result occurs because of how the IRD deduction is calculated. Recall that the IRD deduction is for any estate taxes that were incurred due to pre-tax IRA assets. As we saw earlier, for a given IRA, paying estate taxes and getting the IRD deduction nets out to the equivalent of converting the account (to eliminate the income taxes from the estate) and paying estate taxes on the remainder. *However*, this only applies in situations where *all* of the pre-tax IRA assets yield an IRD deduction. In the case presented in Figure 6, this is no longer the situation. Instead, only $2.5M of the $4M traditional IRA is subject to estate taxes, and thus only $2.5M of the IRA generates an IRD deduction. As a result, completing a Roth conversion produces additional wealth, because it reduces the estate for the last $1.5 million of the IRA that would not have otherwise produced an IRD deduction. In fact, the $1.5 million that does not yield a 30% income tax deduction on a 45% estate tax payment precisely accounts for the difference between the two scenarios ($1.5 million x 30% x 45% = $202,500, the exact amount of wealth created via the Roth conversion).

This unique situation - where a Roth conversion produces Federal estate tax savings, despite the IRD deduction - only occurs in a specific set of circumstances though. In particular, the benefit only occurs to the extent that the IRA cannot enjoy a full IRD deduction, which means there must be enough total assets to be subject to estate taxes, but the total amount of taxable accounts must be less than the estate tax exemption (such that a portion of the IRA falls below the estate tax exemption and doesn't receive the IRD deduction). To the extent this situation occurs, it's also important to note that the benefit only occurs if enough of the IRA is converted to fall below the IRD threshold. For instance, in Figure 6, if the client only converted the first $2.5M of the IRA (the amount above the estate tax

Figure 6. Illustration of Roth conversion impact where estate is primarily IRA assets.

	Traditional IRA scenario		Roth conversion scenario	
	Traditional IRA	Other Assets	Roth IRA	Other Assets
Gross value	$4,000,000	$2,000,000	$4,000,000	$800,000
Total estate		$6,000,000		$4,800,000
Estate tax @ 45% over $3.5M		$1,125,000		$585,000
Net estate		$4,875,000		$4,215,000
IRD deduction	$1,125,000		$0	
Amount of IRA taxable	$2,875,000		$0	
Remaining income tax		$862,500		$0
Net after-tax value		**$4,012,500**		**$4,215,000**

exemption and eligible for the IRD deduction), there would be no difference in the final after-tax wealth. The entire amount of wealth created occurs only for the *last* $1.5 million that is converted - and the benefit can only occur *after* the first $2.5 million has already been converted.

Nonetheless, because of the interplay between income taxes, estate taxes, and the IRD deduction, estates with a large portion of assets in pre-tax accounts, that also include taxable accounts that add up to less than the total estate tax exemption amount, may be able to produce a Federal tax savings with a Roth conversion, in addition to any potential state estate tax savings.

Applying The Rules and the Exceptions

Current Law

As discussed earlier, the basic comparison of a Roth versus traditional IRA account is driven by the tax-equivalency principle, and a decision-making framework that aims to utilize traditional IRAs when tax rates are higher now and lower in the future, and to a Roth IRA when tax rates are lower now and higher in the future (i.e., pay the tax liability when the tax rate is lower). In turn, there are three exceptions to this rule, which can lead to a point where a Roth IRA is favored even if tax rates are lower in the future: avoiding RMDs, paying taxes with outside dollars to avoid the impact of the embedded tax liability on traditional IRA limits, and mitigating potential state or Federal estate taxes.

In any event, to make a decision about whether the Roth or traditional IRA is favored (either for new contributions, or to complete a Roth conversion), one must still make a forecast about an individual's future tax rates to compare to the current tax rate. Only by assessing the current and likely future tax rates, can it be determined whether future tax rates will be high enough to favor a Roth account over a traditional account (either by being outright higher, or by being lower but still high enough to be favored after accounting for the exceptions mentioned earlier).

Looking back in history, the principle behind the creation of traditional IRAs (and also 401(k)s) was the idea that individuals could save money during their working years (when their tax rates were higher due to employment income), and would then be able to withdraw in the future when tax rates were lower (as individuals transitioned from a higher level of employment income to a more modest level of retirement income). Wealth would be created both through tax-deferred growth, and especially because taxable income would be deferred until a lower-income-tax-rate environment.

Although this framework may be an accurate characterization for some clients, the decision-making process requires a more client-specific analysis, in particular because the amount of wealth accumulation necessary to sustain retirement income may separately create enough taxable income to result in a higher tax rate. In other words, the client may have no more employment income, but the size of the savings necessary to replace those cash flows and the taxable income it produces may still result in a similar, or even higher, tax rate. Thus, a client-specific estimate of future tax rates, based on the client's own anticipated wealth savings and creation over time, becomes especially important.

To a large extent, future tax rates can be estimated by identifying the amount of future retirement income that an individual needs, and the amount of assets that will be necessary to sustain it. For example, if an individual's spending goal was $4,000/month (or $48,000/year), which would require approximately $1,070,000 of investment assets (assuming a 4.5% withdrawal rate). If the investments were held in a balanced 60/40 portfolio, this would imply a $642,000 equity investment and a $428,000 fixed investment. If equities are assumed to generate an average of 3% dividends and 7% capital gains, and bonds are assumed to produce a 5% yield, the taxable income of the entire portfolio can be derived for an average year. For instance, using the numbers above, the portfolio would generate $19,260 of dividends, $44,940 of capital gains, and $21,400 of bond interest, for a total of $85,600 of total investment income. These amounts could then be referenced against the tax tables to determine the likely tax bracket that the individual would face. Thus, if the individual also held a $400,000 IRA, the current tax rate could be compared against this anticipated future tax rate to determine whether a Roth conversion of this IRA would be beneficial. If the IRA was part of the $1,070,000 of future assets, the accounts could be further apportioned to determine the likely amount of income as IRA withdrawals and from the taxable portfolio, and again the future tax rate could be derived. Alternatively, the planner can also project future account balances and inflation-adjust the tax bracket thresholds to calculate these potential tax liabilities on a future account value, especially if significant time

remains for the accounts to grow in excess of the tax bracket inflation adjustments.

In many cases, planners assume that a significant amount of retirement wealth will inevitably lead to the highest tax rates, although in reality the results are often far more nuanced. For example, assume a client who is retiring soon and is projected to have $5,000,000 in wealth, including $3,000,000 in a taxable account and a $2,000,000 IRA, which will be used in addition to $2,000/month in Social Security to provide for a $200,000+/year standard of living. Given that the client will face an RMD of nearly $75,000 at age 70 ½, and even more in subsequent years, in addition to the significant income that a $3,000,000 taxable portfolio will provide, many planners would likely assume that this client will face one of the top tax brackets in the future, making a current Roth conversion highly desired to avoid higher future tax rates. But is a Roth conversion really appropriate for this client?

A further analysis reveals this may not be the case, and that even by age 70 ½ the client's tax bracket may not be nearly as high as anticipated. Using the methodology discussed earlier, an estimate of the client's income can be broken down as follows:

- $24,000 Social Security
- $72,993 from first RMD

60/40 portfolio for $3,000,000 taxable account, which provides:
- 3% dividend on $1,800,000 = $54,000
- 7% capital gains on $1,800,000 = $126,000
- 5% interest on $1,200,000 = $60,000

Portfolio subtotal: $240,000

Total income: $24,000 + 72,993 + $240,000 = $336,993

A first glance at a total income of $336,993 would likely lead many to conclude that the client is in fact facing one of the top tax brackets, and therefore that an early Roth conversion would likely be favorable given the high future rate rates. However, it is important to understand how the tax liability on income is calculated under the tax code – in particular, regarding the fact that the tax rates are applied to ordinary income *first*, and capital gains and (qualified) dividends are stacked on top of ordinary income second.

A breakdown of the client's income would show the following:

- Ordinary income: $60,000 (bond interest) + $20,400 (85% of Social Security taxable) + $72,993 RMD = $153,393

- Capital gains and qualified dividends: $180,000

In addition, deductions are counted first again ordinary income. Thus, a married retired couple in 2009 would receive a standard deduction of $12,500 (including the increase for being over age 65) and two personal exemptions of $3,650 x 2 = $7,300, for a total of $19,800 in deductions. As a result, the client's tax liability would be calculated as follows:

$153,393 - $19,800 = $133,593 of ordinary income

Tax liability = $9,350 + 25% of the excess over $67,900 = $9,350 + $16,423 = $25,773

$180,000 of capital gains and qualified dividends

Tax liability = $180,000 x 15% = $27,000

Total tax liability = $25,773 + $27,000 = $52,773

A few conclusions are notable from the results above. First and foremost, the total tax liability was $52,773 on a gross income of $336,993. This represents an effective tax rate of only 15.7%! In addition, at the margin the client's ordinary income never even crossed above the 25% tax bracket! Thus, converting the IRA to a Roth IRA would only be avoiding 25% future tax rates, nowhere near the 33% or 35% top tax brackets, and in fact might make the entire conversion transaction undesirable.

Thus, to say the least, it is not a foregone conclusion that clients who will have even millions of dollars of future wealth will be subject to the top tax rates (although certainly, at some point above $10,000,000 roughly, the sheer amount of assets producing taxable income may force the top tax brackets, especially if a large portion of the assets are pre-tax). In point of fact, none of this client's income even reached the 28% tax bracket,

The Kitces Report © 2008 www.kitces.com

Written and edited by Michael E. Kitces

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form by any means without the prior written permission of Michael Kitces.

much less the 33% or 35% brackets. The client's overall tax liability was only an effective rate of 15.7%. If the client had been invested in municipal bonds for the fixed income portion of the taxable account, the total ordinary income after deductions would have been only $73,593, and virtually all of the client's IRA distribution would have been taxed at only the 10% and 15% brackets! And obviously, for the overwhelming majority of clients with "more modest" wealth, there is an even higher probability that the actual future tax rates that the client will face will be similarly modest if derived primarily from portfolio income.

Future Changes in Tax Law

The preceding analysis evaluates future tax rates in the context of today's tax brackets – ignoring, for the moment, the possibility that the tax law itself may be changed in the future.

However, future tax law changes cannot be ignored entirely. Although they are certainly difficult to forecast, many planners readily acknowledge that current budget deficits, in addition to the rising specter of Social Security and especially Medicare deficits, significantly increase the likelihood of an increase in future tax rates.

In many cases, planners assume that the implied "need" for higher future tax inflows for the Federal government will lead to higher tax rates *in the context of IRA distributions*. However, caution should be used in this assumption. There are many ways in which future tax revenues for the Treasury could be increased *without necessarily increasing the effective tax rates on IRA distributions*, including:

> *National sales tax* – potentially levied nationwide on the sale of goods, in a similar manner to how it is applied in many states
>
> *Value-added tax (VAT)* – an indirect form of consumption tax widely used in Europe, based on taxing goods as they are developed and improved in the process of being prepared for delivery to consumers (but in the end, this form of taxation is based on consumption {goods purchased}, not income)
>
> *Payroll tax (increase)* – the primary method by which we already tax in order to collect revenues for Social Security and Medicare, levied on earned income and not investment income (nor on IRA withdrawals)

In addition to the above taxation mechanisms, there is also the possibility that even if higher tax rates are established, that additional tax relief may be provided to retirees and/or IRA withdrawals in particular, especially given the size of the prospective retiree/baby boomer voting block. This may result in a lower tax rate for IRA withdrawals and/or retirees, even if overall income tax rates are increased, through any number of potential "special retiree exemptions or deductions."

Thus, although higher income tax rates in the future are certainly a possibility, it is important to bear in mind that there are many ways for the Federal government to raise tax revenue that does *not* necessarily require an *income* tax rate increase on retirees and their IRA withdrawals. Social Security and Medicare deficits could be addressed by raising the tax rates under the approach currently used to fund those programs - the payroll tax system - without imposing any additional tax liability on IRA withdrawals. And various forms of consumption taxes on goods produced and purchased (e.g., a national sales tax or VAT) would also not affect IRA withdrawal tax rates.

This is turn means that it may not necessarily be desirable to complete Roth conversions in sheer anticipation that future income tax rates will be higher - *even if* the planner is correct about an overall forecast of higher taxation across the broader economy - because tax increases may not necessarily manifest as an increase in the rate of taxation on IRA withdrawals. Given that there are many ways to raise taxes without affecting IRA withdrawals, and especially given the earlier analysis showing that in many cases a retiree's future tax rate will likely be lower (possibly significantly lower) due to the composition and tax nature of portfolio income, planners should be highly cautious about seeking significant Roth conversions simply in anticipation of higher tax rates if the client's situation does not already justify the conversion when projecting current rates.

Upcoming Changes in 2010

As discussed earlier, there are two important developments coming with respect to Roth conversions in 2010.

First, the $100,000 AGI income limitation on Roth conversion eligibility will be permanently removed, allowing any client to complete a Roth conversion beginning in 2010 and in any future year. For many wealthier clients who have had persistently high income for many years, this change in 2010 may create the

client's first ever opportunity to complete a Roth conversion if desired.

In addition, a one-time rule applicable for 2010 conversions only gives taxpayers the option to report the amount of income from a Roth conversion evenly in 2011 and 2012, ostensibly with the goal of spreading out the amount of income and therefore the impact on marginal tax rates over two years instead of lumping into a single year. Individuals will have the option to choose *not* to use the two-year averaging provision if they wish.

In practice, though, neither of the new Roth conversion provisions may be as desirable as is first apparent. While it is true that the repeal of income limits for Roth conversions will create new first-time conversion opportunities for many clients, the fact remains that Roth conversions are best suited for those who currently face lower tax rates now (and anticipate higher tax rates in the future). Thus, ironically, removing the Roth conversion income limits opens up the opportunity for Roth conversions to those who have higher income, and who already face above-average income tax rates, and thus who are actually less likely to find the Roth conversion favorable over the long run. It is certainly true that in individual cases, some may wish to complete a Roth conversion with income over $100,000 of AGI because the taxpayer still anticipates that their tax rate will be even higher in the future – especially since for married couples, an AGI of $100,000 still corresponds to "only" a 25% marginal income tax rate. Nonetheless, as income increases further, the burden to find a more desirable future tax rate becomes more difficult; planners who are excited to complete Roth conversions for their wealthiest clients in the top tax bracket should be cognizant of the fact that it may be very difficult to actually face higher tax rates in the future, even if significant wealth accumulation is anticipated, because of the nature of portfolio income taxation (with preferential rates for qualified dividends and long-term capital gains) for those retired clients in the future. At a minimum, a thorough analysis of the client's individual situation is merited as the current tax rate on the Roth conversion increases, to be certain that a tax-adverse result doesn't occur, after accounting for the factors and exceptions discussed earlier.

Some planners may also need to be especially cautious in seeking out the two-year-income-averaging provision that applies in 2010. In many cases, the income averaging provision may actually be *less* favorable under current law, because current income tax rates are scheduled to sunset at the end of 2010 and a client's income tax rates will actually be *higher* in 2011 and 2012 by a few percentage points. Thus, for some clients, electing the 2011/2012 income averaging provision will only push Roth conversion income into future years with higher income tax rates, rather than simply recognizing the full tax impact in 2010. This may be especially true for relatively modest Roth conversion amounts; for example, a $50,000 conversion may not even push a client out of his/her current tax bracket, and consequently there is little marginal benefit to spreading the income out to recognize $25,000 in 2011 and $25,000 in 2012, especially if tax rates will be higher in those years. On the other hand, if the client is considering a $300,000 Roth conversion that will likely push income into the very top tax bracket, income spreading may still be desirable, regardless of the fact that each tax bracket will increase slightly, because the results would still be more favorable than crossing all the way to the top tax bracket in 2010. Either way, planners will likely wish to monitor income tax law changes through the remainder of 2009 and early 2010, to see if the income tax brackets themselves are altered further (as there are currently proposals being considered in Congress to make at least the bottom four tax brackets permanent so that they will not increase after 2010). In any case, the decision to spread income or not should still be very client-specific, and depends both on the size of the Roth conversion itself, and the rest of the client's overall tax situation anticipated in 2010, 2011, and 2012.

In the end, Roth conversions for higher income clients will become possible in 2010, which does open up new opportunities for clients. But many clients should be cautious about converting significant IRA amounts if facing top tax rates, and may need to be especially cautious about spreading income over two years with the potential for higher tax brackets starting after 2010.

Strategies for Implementation

To the extent that the decision to contribute to a Roth versus traditional IRA results in a wealth outcome that is unknown until the distant future, it inherently represents a decision that includes risk - the possibility that the future tax rate is not as anticipated, resulting in a negative accretion of wealth (either by converting when you shouldn't have, or not converting when you should have). To this extent, some planners consider utilizing "tax diversification" as a strategy to manage this risk.

At a basic level, tax diversification represents a reasonable approach to manage the fact that future tax rates, although they can be forecast to some extent, are still very uncertain. However, even a tax diversification approach should still be cautious to take into account the current environment. Thus, for example, completing a Roth conversion for a high income client already in the top tax bracket is probably an unnecessarily risky transaction itself; it other words, it may be a diversification approach, but to convert at an already-high tax rate sets a very high tax threshold to clear.

Thus, rather than establishing a Roth account or converting simply for the sake of having a Roth account to tax-diversify, an alternative approach is what might be called "opportunistic tax diversification" - to seek out a conversion (or Roth contribution) on a year-by-year basis when a favorable tax environment presents a desirable opportunity to increase the amount of Roth dollars. Under this approach, the decision whether to contribute to a Roth IRA (or convert to a Roth IRA) is made on a year-by-year basis, depending on the tax situation for that particular year. For instance, the planner might target contributing to a Roth IRA any year the individual's tax bracket will be 25% or less (anticipating tax rates at least that high in the future for that particular client), but relying on traditional IRA contributions and/or not doing any Roth conversions if tax rates are higher. For many clients, this may lead to a systematic process of doing partial Roth conversions opportunistically to fill the lower tax brackets year after year, while cutting off the Roth conversion amount before it reaches higher tax brackets. This strategy may be especially effective for retirees, whose taxable income often varies significantly from year to year based on portfolio activity. In some cases, the client may even be able to do a partial Roth conversion to offset negative taxable income in years with excess deductions, effectively producing a zero-tax-liability Roth conversion for a portion of the account.

Bringing It All Together

The starting point for any decision between Roth or traditional retirement accounts is the tax-equivalency principle, and the idea that it is best to pay your taxes when you anticipate the tax rate will be lower - which means using Roth accounts (via contributions or conversions) when your tax rate is low now and higher later, and using traditional retirement accounts when the reverse is true. If the tax rates will be exactly the same now and in the future, the Roth versus traditional retirement account decision yields the same after-tax spendable wealth in the end.

However, there are exceptions to this basic rule. The opportunity to avoid Required Minimum Distributions (RMDs) from a traditional IRA represents a benefit for the Roth account, even if the tax rates do not change, although the benefit is relatively modest unless the client lives *significantly* beyond age 70 1/2 and avoids a large cumulative amount of RMDs. On the other hand, a greater exception to the tax equivalency principle applies anytime an individual can contribute the maximum amount to a Roth IRA, or alternatively can convert to a Roth IRA, and use outside taxable account dollars to pay the associated tax liability. This effectively allows an individual to take a traditional IRA - a tax-deferred investment that is combined with a deferred tax liability inside the account - and turn it into an entirely tax-preferenced savings account by using up tax-inefficient outside dollars in the process. Similar to avoiding RMDs, the benefit of this transaction depends on the time period over which the taxable account is no longer growing in a tax-inefficient manner; however, since the benefit begins to accrue immediately as of the time the Roth account is created/contributed/converted, it allows for a far longer accumulation period and a far greater benefit than simply by avoiding RMDs. Notably, this time period may even extend to include beneficiaries who stretch the traditional or Roth IRA distributions after the death of the original owner, to continue maximizing the value of the deferral.

In select situations, an individual can also enjoy an estate tax benefit from a Roth conversion as well, although the benefits tend to be at the state estate tax level rather than the Federal estate tax level, unless the pre-tax retirement accounts are the majority of the estate, as discussed earlier.

Outside of the estate tax planning situation, most clients should evaluate the Roth versus traditional IRA decision by starting with a comparison of current versus future tax rates, while being certain to take into account a realistic tax rate for both by properly considering what the marginal tax rate will be on IRA withdrawals (including recognition of how portfolio income may not necessarily increase IRA withdrawal tax rates, and the various ways that future tax law changes may occur). If the current tax rate is lower than the future tax rate, a Roth IRA will clearly be more favorable. If the current tax rate is equal to the future tax rate, or future rates are anticipated to be lower, then the analysis needs to go a step further, to consider how much lower future tax

rates can be and still allow the Roth account to be favored. This in turn will depend on how long the client is likely to live (to determine the value of avoiding RMDs), and how long the account is likely to grow and remain intact (which depends on the client's current age, future withdrawal and spending goals, and possibly the time period over which beneficiaries may stretch the retirement account after the death of the original owner), assuming that the client does in fact have other outside taxable dollars available to cover the tax liability for the contribution or conversion. In any event, though, if the future tax rate is anticipated to decline more than 10% or so, it is unlikely the Roth IRA will be favorable except in the most significant multi-decade deferral periods.

By following this process, planners can be certain to take advantage of Roth contribution or conversion opportunities for clients, without necessarily "over-converting" and creating unnecessarily large current tax liabilities that may actually result in *less* future wealth.

Summary

Overall, the Roth versus traditional IRA presents a favorable opportunity to time tax events in a manner that allows the taxpayer to pay a tax liability when tax rates are anticipated to be lowest. This opportunity to time the taxation of retirement savings alone can present a significant opportunity to enhance wealth, and the longer the time period and greater the growth rate of the savings, the more wealth that is accrued via a favorable tax timing decision.

Above and beyond that, the tables tilt slightly towards a Roth IRA simply by virtue of the opportunity to avoid Required Minimum Distributions, enjoy occasional state or sometimes Federal estate tax savings, and especially by using outside taxable accounts to maximize Roth amounts by avoiding how the embedded deferred tax liability inherent in pre-tax traditional IRAs crowds out a portion of the account. These additional advantages of the Roth IRA allow taxpayers to enjoy a benefit for the Roth account, even if future tax rates are actually slightly lower.

Nonetheless, the Roth IRA is not a panacea. Converting at a tax rate that is too high currently can cause a significant loss in wealth over time if tax rates are actually much lower in the future, whether due to a change in the client's overall income level, the composition of the income (e.g., capital gains and qualified dividends that don't increase IRA ordinary income tax rates), or because of changes in the tax law that do not necessarily increase (or cause an outright decrease in) the income tax rate applicable to IRA withdrawals. And although a tax diversification approach can be an effective means to manage this risk, it is still not a substitute for being cautious about paying a high current level of taxation on a Roth contribution or conversion.

What did you think?

Hopefully you found this latest issue of The Kitces Report to be of value to you. However, since it is produced for you, the reader, we would like to hear from you about how the style, format, and content of the newsletter could be further improved to make it more valuable for you.

Please let us know what you think by emailing us at feedback@kitces.com! Thanks in advance for sharing your thoughts!

The publisher of The Kitces Report takes great care to thoroughly research the information provided in this newsletter to ensure that it is accurate and current. Nonetheless, this newsletter is not intended to provide tax, legal, accounting, financial, or professional advice, and readers are advised to seek out qualified professionals that provide advice on these issues for specific client circumstances. In addition, the publisher cannot guarantee that the information in this newsletter has not been outdated or otherwise rendered incorrect by subsequent new research, legislation, or other changes in law or binding guidance. The publisher of The Kitces Report shall not have any liability or responsibility to any individual or entity with respect to losses or damages caused or alleged to be caused, directly or indirectly, by the information contained in this newsletter. In addition, any advice, articles, or commentary included in The Kitces Report do not constitute a tax opinion and are not intended or written to be used, nor can they be used, by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer.