KANAWHA
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This Quarter's Highlights

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Kanawha Currents

Consider Going for the (Roth) Conversion

This time of year we often witness football coaches stressing over the decision to go for a two point conversion at a key moment in the game. Owners of traditional retirement accounts sometime face a different dilemma related to conversions. The question for them is whether or not they should consider converting their pre-tax retirement account to a Roth IRA or Roth 401(k). Roth conversions cause immediate tax consequences, but may yield long-term benefits.

Every dollar converted to a Roth is treated as ordinary income for tax purposes in the year of conversion. Since most individuals are trained to defer taxes, many IRA owners have reservations about converting money into a Roth. There are, however, some enticing benefits to Roth conversions. First, future withdrawals will not be taxable. Second, Roth owners are not required to take minimum annual distributions after reaching age 70½. Third, retirement account owners considering conversions do not have to convert their entire account. They can choose to make partial conversions. Lastly, those who convert are able to "undo" all or a portion of their converted amounts as long as they do so prior to their tax filing deadline.

The primary question with respect to a Roth conversion is whether paying the taxes now is better than paying the taxes at some point in the future. All other things being equal, the idea of paying taxes sooner rather than later, or "prepaying" taxes, does not resonate with many people. Nor does it often make financial sense. However, if one's tax rate is likely to be higher in the future, or if an IRA owner is not likely to spend his or her IRA money during their lifetime, then a Roth conversion may be worth pursuing.

The basic cost benefit analysis of a conversion is not unlike other financial decisions. Should I give up something today in exchange for some greater monetary benefit in the future? Put another way, should I pay taxes on withdrawals today and, in return, avoid paying potentially higher taxes on withdrawals in future years? The answer really lies within the individual circumstances of the investor. Specifically, what is their tax rate at the time of conversion compared to their expected tax rate at distribution? There are other important potential factors to consider as well. Unlike traditional retirement accounts, Roths do not have mandatory distributions for the owner or spousal beneficiaries beginning at age 70½. So, for those IRA

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owners who are not likely to rely on their retirement accounts during their lifetimes, a Roth conversion may be a way to gain more tax control. With good planning, one can decide the amount and the timing of the conversion, and also determine what their current marginal tax rate will be on each dollar converted. Those dollars that go into a Roth will no longer be susceptible to taxes, either through investment gains or withdrawals.

Retirement Accounts Primer

Retirement accounts are granted certain tax benefits by law to encourage workers to save for retirement. Inside of these accounts, investment income such as capital gains, stock dividends, and bond interest is not subject to income taxes in the year it is received. This "tax-deferred" growth allows retirement accounts to potentially accumulate faster over time. Both traditional and Roth accounts benefit from the tax-deferral of current investment income.

The primary difference between traditional "pre-tax" funded retirement accounts and Roth accounts is the tax treatment of contributions and withdrawals. A traditional IRA or 401(k) allows savers who are not subject to income limitations to deduct the amount of their contribution from current income. This means that many investors don't pay income taxes on monies that they or their employer contributes to traditional pre-tax retirement accounts. Roth IRA or Roth 401(k) contributions, on the other hand, are made with after-tax dollars. Since there is no tax deduction up front, they benefit from tax-free withdrawals on the back-end as long as the owner is at least 59½ and has held the account for five years or more.

Elimination of Roth Conversion Income Limit:

The Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005 repealed the $100,000 income limitation for Roth Conversions. The new rule didn't actually go into effect until 2010. It allows anyone who owns a traditional IRA to convert to a Roth IRA, regardless of income. While there are still income limitations which determine annual Roth contribution eligibility, there is no longer an income limitation for Roth conversions.

Conversion Opportunities

This basic premise of how contributions and withdrawals are taxed within traditional and Roth accounts is necessary to understand Roth conversions. Like any withdrawal from a pre-tax funded traditional retirement account, monies converted from a traditional retirement account to a Roth are also subject to the income tax toll. Therefore, those who are considering a Roth conversion should have adequate liquidity to pay any current tax liability. The converted dollars are treated as current income and the taxes owed are dependent upon the taxpayer's marginal tax rate.

So when might a traditional IRA or 401(k) owner choose to do a Roth conversion and pay the taxes now instead of later? An IRA owner with unusually low taxable income in a given year or years may have an opportunity to convert a portion of his or her retirement account at a relatively low marginal tax rate. Also, those individuals who know their income is going to be higher in future years are candidates for current conversions. Others may be attracted to the additional tax control that a Roth offers since minimum taxable distributions are not required beyond the age of 70½. Conversions may be most appropriate for those IRA owners with large balances who do not plan to withdraw from their accounts and like the idea of passing an asset to their heirs who can then "stretch" tax-free distributions over their lifetimes. While children (or non-spouse beneficiaries) are required to take annual distributions based on their life expectancies, their withdrawals are not subject to income taxes. This

could be a significant long-term benefit. Theoretically, Roth IRAs could yield tax-free growth and income to the next generation for decades to come. This could be even more advantageous for families whose children are likely to be in high tax brackets.

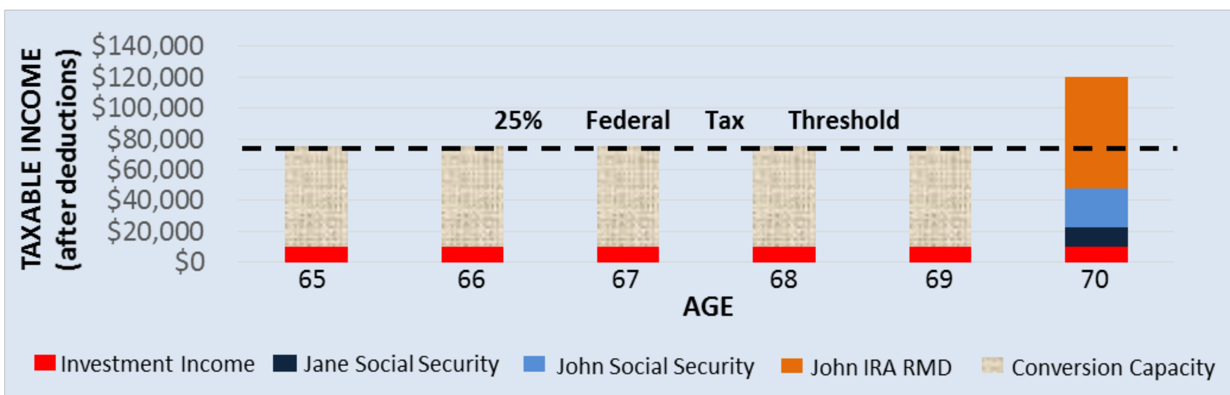
Unintended Consequences:

It is important that IRA owners *not* look at the Roth conversion decision as an all-or-nothing proposition. Choosing to convert one's entire IRA balance in one year could have serious tax implications. Without proper planning, a large conversion could accelerate you into a higher marginal tax bracket, expose you to AMT, and lead to higher future Medicare Part B and D premiums. One should also be aware of how converted dollars might trigger lost deductions and cause a portion of their Net Investment Income to be subject to the Medicare surtax. Fortunately, account owners are able to make partial contributions and, with good planning, can determine annual amounts that will "use up" their current bracket and avoid unintended consequences. Roth Recharacterization rules can also prevent careless mistakes. One should only consider converting money that he or she does not plan to access within five years and until after turning age 59½.

Roth Conversion Planning Example

Let's say that John Doe, age 65, recently retired with a 401(k) valued at $2,000,000 (funded entirely with pre-tax dollars) and immediately transferred these monies into a Rollover IRA. John files a joint tax return with his wife, Jane. Since John is no longer working, their only income is what they receive from a couple of joint investment and savings accounts. This is projected to be approximately $20,000 for the next few years. They plan to live off this income as well as spend down some of their non-retirement accounts until their age 70. John and Jane are both planning to defer the beginning date of their Social Security retirement benefits to age 70. Given their new, relatively low marginal income tax rate of 15%, the Does are considering doing annual Roth conversions for a portion of John's Rollover IRA account.

There are a few things to keep in mind with the Doe's situation. First, this potential planning opportunity has a finite life. Their income is expected to increase significantly at their age 70 since John will be forced to begin taking annual required minimum distributions (RMD) from his IRA (approximately $73,000 based on today's figures). Also, he and Jane will begin taking their Social Security retirement benefit of approximately $45,000. Since a majority of their Social Security will be subject to taxes and all of his RMD will be taxed, their taxable income may increase by more than $100,000, which would put them firmly in the 25% marginal bracket. This doesn't mean that all of his $73,000 RMD would be taxed at 25%, but based on current projections, a majority of his future IRA distributions are likely to be taxed at the higher 25% rate (assuming current tax bracket and rates).



So, for the next five years, or between their ages of 65 and 69, the Does may benefit from a series of partial annual conversions. Ideally, they would work with their tax accountant to project their current year's income, and then fill up their current tax bracket. Let's assume, based on their $20,000 in investment income and $10,000 in deductions, that their projected taxable income is only $10,000. Knowing the 15% marginal bracket for joint filers tops out at $75,300 (2016 figures), they could convert up to $65,300 and not exceed the 15% threshold. The Does could use a series of annual conversions over the next few years to accumulate a significant Roth IRA balance which could be immune from future income taxes and RMDs. In the event they do a conversion in a year and then have unexpected income later in that same year, they could utilize the Roth Recharacterization rules to undo the conversion.

Roth Recharacterization:

A Roth conversion does not have to be an irrevocable decision in a given tax year. Individuals who convert monies to a Roth are given a "do over" through something called Roth Recharacterization. This allows them to undo their conversion if circumstances change prior to the current year's tax filing deadline. For example, a recharacterization might be employed if one's account value declines significantly due to market fluctuations after doing the conversion. Let's assume John converted $100,000 of his Traditional IRA to a Roth IRA and the value declines from $100,000 when the conversion was completed on June 1st to $80,000 the following March 1st. John may not want to pay income taxes based on $100,000 of ordinary income knowing the Roth IRA is now only worth 80% of this amount. Fortunately, he is given the rare benefit of hindsight and has the ability to move these monies back into the traditional IRA with no penalty under the Recharacterization rules. This may also apply in situations where one's taxable income during the current year increases significantly after the decision to convert was made.

Through careful planning, owners of traditional IRAs and 401(k)s may recognize opportunities for Roth conversions. The most important factor in determining whether this makes financial sense is the marginal tax rate at the time of conversion compared to the expected future tax rate at distribution. For many, the concept of accelerating taxes, regardless of potentially lower current rates, is not palatable. For others, the ability to make partial conversions at relatively lower tax rates is an enticing financial proposition. Being able to transfer funds to an account that will not require mandatory distributions during the owner's lifetime may also be appealing. Finally, a Roth's ability to pass tax-free distributions to the next generation for decades to come may be worth strong consideration for certain families. Of course, much of what has been discussed is based on current income tax laws. Future legislation can always alter current and future planning scenarios.

The IRA Aggregation Rule:

Conversions from traditional IRA's and 401(k)'s that have been partially or fully funded with *after-tax contributions* will not be fully taxable. Investors, however, are not able to convert only their after-tax contributions or accounts due to the IRA aggregation rule. For example, let's assume an individual wants to convert $25,000 of her traditional IRA money. Let's also assume she has two different IRAs totaling $100,000, one of which was funded with $25,000 in after-tax contributions. Instead of being able to isolate the $25,000 in after-tax monies and avoid paying taxes on the conversion, a pro-rata calculation will be applied to determine the taxable amount of the conversion. In this example, 75% of the conversion, or $18,750, will be taxable and 25%, or $6,250 will be tax-free ($25,000 in after-tax contributions divided by the total IRA balance of $100,000, times the $25,000 conversion amount).

This is intended to be for informational purposes only and should not be interpreted as tax or investment advice. Consult your tax professional for advice regarding your specific circumstances. Future tax legislation can alter planning assumptions. Assumptions are based on current year tax figures.