Best Times to make a Roth Conversion

Abstract

Many people hear that Roth IRAs are better than regular IRAs!
Roth IRAs are tax free on withdrawals.
Is there a back door way to stuff large assets into a Roth?
IRAs grow tax-deferred, Roths grow tax-free!

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"Everything happens for a reason, but sometimes, the reason is that you make bad decisions"

Unknown

"The best way to teach your kids about taxes is to eat 30% of their ice cream cone"

Bill Murray

"Little by little, one travels far"

Tolkien

Roth: Rules of the Road

First, it is important to recognize the difference between a "conversion" and a "contribution". A "contribution" is when you take after-tax income and contribute it to your Roth-IRA. The IRS limits the amount of these contributions and you will get no tax break for making a contribution (but also pay no tax because the money is from your working income upon which you have already been taxed). A "conversion" is when you take money that you previously contributed to a regular IRA, then "convert" it, or move it over from your IRA to your Roth-IRA. "Conversions" are taxable events, as with anytime you take money out of a traditional IRA. So, when you convert, you are choosing to pay the tax now, rather than continue to defer paying the tax until later – with the eventual benefit of having the money in a Roth.

A Roth-IRA is one of many types of IRAs. Most people think of the regular or Traditional-IRA (T-IRA), but in addition, there are SEP-IRAs, Simple-IRAs, Beneficiary-IRAs, and more.

In retirement, withdrawals from a Roth IRA are never mandatory, and are tax free. Conversely, withdrawals from a regular IRA are taxed as income at the time of the withdrawal, and there are mandatory withdrawals from your regular IRA which begin at age 72 (prior to 2020, mandatory withdrawals began at age 70.5).

A person has some grace period to change their mind about a contribution or a conversion. A person can always withdraw the funds they have invested (converted or contributed) into a Roth-IRA (no tax if you change your mind on the approved IRS schedule). A person has some time to un-convert money that has been converted from a T-IRA to a Roth and put the funds back into their T-IRA.

Additional Roth rules: Remember, a Roth IRA is intended to be a retirement fund, so taking your gains/profits out before 59.5 years of age may trigger a 10% penalty. An investor can always pull out their contributions (not their gains) without paying any tax. Finally, to achieve tax free withdrawals in retirement, you have to have had your Roth account open and funded for at least five years.

Why is it so hard to build up a Roth IRA retirement account?

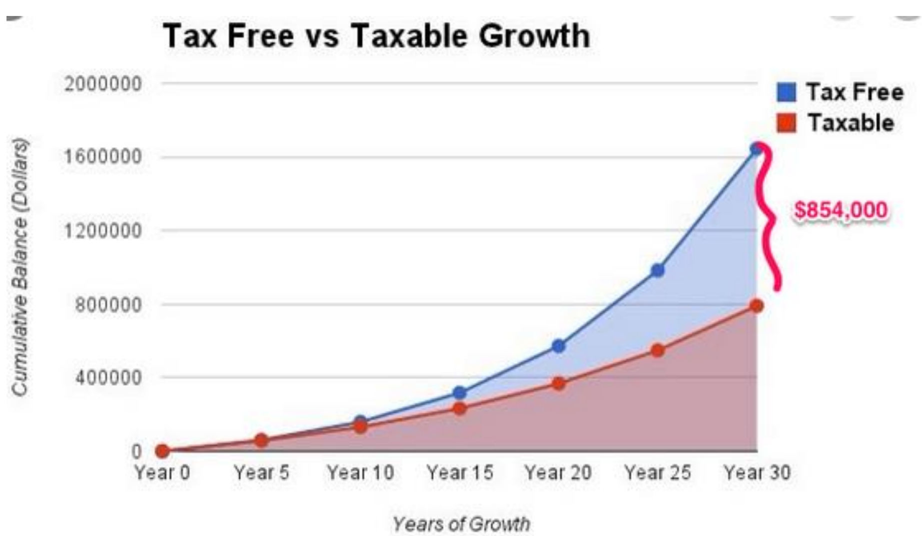
There are only 2 ways to get money into a Roth IRA and achieve tax free investing with tax free withdrawals

1) If your income is below the IRS limits (in 2020, the Married filing Joint limit was 206k, single $139k) then you can slowly, each year make the maximum contribution to a Roth IRA account (in 2020 the max Roth contribution was only $6k + another $1k if you are over 50 years old).
2) There are no income limits to making a conversion. The following steps are sometimes referred to as a Back Door Roth because it works around the income limitations from (1) above.
    a. Withdraw a large amount of money from your Traditional-IRA (which perhaps came from rolling over your 401k)
    b. Pay the tax on the withdrawal from step (a) above
    c. Send the funds to your Roth IRA as a conversion

Taxes

Taxes are a big part of the decision to utilize a Roth as one component of your retirement savings. Since taxes are a very "individual" thing, therefore, there is no one correct answer on whether or not you should convert a traditional IRA to an IRA. Yes, calculations can be done, but usually, those calculations contain some "assumptions".

Usually when people ask about a Roth conversion, they are thinking about taking advantage of the ideas presented in the following graph:



But notice that it takes quite a few years before the lines start to diverge and you start to reap the benefits and rewards of tax free growth. In fact, if you're thinking about a T-IRA to a Roth-IRA conversion, you have to calculate the fact that you will pay income tax on the T-IRA withdrawal, so your benefits will take even longer to accrue. (When you withdraw money from a T-IRA, the amount of the withdrawal is added to your gross income for calculations of income tax purposes.)

T-IRA -> Roth-IRA conversion requires these steps:

1) Withdraw funds from T-IRA today -> pay taxes at today's income tax rates
2) Take cash remaining from withdrawal proceeds -------> Roth-IRA

If you can pay the taxes without using cash from the T-IRA withdrawal, then all your T-IRA money can transfer over to the Roth-IRA and you can shorten the timeframe it takes to achieve maximum benefits from tax-free growth (as per the above chart). But it you can't pay the taxes using some other money besides your T-IRA money that you are withdrawing, then only some portion of the money in your T-IRA will end up in your Roth-IRA.

So, in effect, to suffer the short term tax consequences of a conversion is really like biting the bullet. It will hurt in the short run. You are making the decision to suffer the short term pain in order to achieve long term gain. Usually, that's a good idea, but what if you don't have "long term"? What if you are already 65 years old and you statistically only have about 20-25 more years left?

What is the best way to get involved? When is a good time to do a conversion?

If you are young enough to capitalize on significant benefits from a conversion, then there are a few times when doing a Roth conversion makes sense.

1) If you have a tough year, maybe a lost job for six months, and your income is relatively lower this year, then it might be a good time to convert T-IRA money to Roth-IRA.
2) If you start a new business and the revenues and earnings aren't piling up quite yet
3) If you usually make 50% of your income from stock options, or by hitting sales targets, yet this was a down year so your overall income level is lower, therefore your tax bracket is lower.

The above opportunities are times when your relative tax bracket is a bit lower, and thus withdrawing funds from a T-IRA (and therefore paying tax on those funds as if it was income) may not be so painful.

Example: converting T-IRA to Roth during a low income year

John & Nancy usually make about $230k/year from their jobs. But this year, John started his own business and has been successful. However, due to the timing of those revenues being delayed, John and Nancy's taxable income this year is only $120k. If they withdraw $110, from a T-IRA and convert it to a Roth-IRA, then their taxes will be about the same as usual. Using the tax brackets from tax year 2020:

Converting T-IRA to Roth during a low income year

Item Description	Last Year	This Year	Convert $110k to Roth this year
Gross Income	$230,000	$120,000	120,000 + 110,000 = $230,000
Taxes Paid	$41,400	$16,000	$41,000
Avg Tax Rate	18%	13.3%	18%
Marginal Tax Bracket	24%	22%	24%

Source: Randy Warren • Created with Datawrapper

Notice in the above example how having a low income year reduces both the average tax rate the John & Nancy's tax bracket (marginal rate). But converting money from a T-IRA to a Roth is a taxable event. So, when converting the $110,000, they will pay taxes on that conversion amount just as if the $110,000 were income from a job. So, their tax situation reverts right back to their "Last Year" high income year, in terms of average tax rate and marginal tax rate (bracket).

But when the conversion is completed, if they have paid the income tax on the conversion amount from savings, they will have a Roth with $110,000. If however, when they converted, if they used some of the T-IRA money to pay the tax on the conversion (tax of $25,000), then their initial Roth amount is only $85,000 ($110,000 conversion withdrawal less $25,000 tax). It will take many years of tax free growth to make up for that $25,000 tax hit.

Example: Tax rates may rise in the future

Bob (50 years old, married filing jointly) believes that tax rates will be going up in the future and would prefer to bite the bullet today rather than risk the chance that rates will go higher in the future. Bob makes $180,000 gross income today. Bob thinks that his marginal tax rate could go as high as 28% in the future. Does it make sense to convert today? Since Bob would not be paying any tax on his IRA withdrawals until retirement (age 72), he won't be paying any tax for many years. Without conversion, today's IRA will grow tax deferred for 22 years. Today's IRA is worth $250,000. At age 72 with a 6% annual average return, Bob's IRA will be worth about $900,000, not including additional contributions between today and age 72. For round number purposes, lets assume Bob's IRA with additional contributions is worth $1m at age 72 when Bob is forced to take withdrawals. Bob and his wife will receive typical social security checks and have typical deductions to taxable income on their returns, both now and in the future.

Tax Rates may rise in the future - without Roth conversion

Item Description	Current Year	Future Tax (age 72)
Gross Income	$180,000	$42,000 ($1m * 4.2% RMD withdrawal rate)
Social Security	0	$40,000 (for Bob and his wife)
Taxes Paid	$29,400	$17000
Avg Tax Rate	16.33%	20.7%
Marginal Tax Bracket	24%	28% <- Bobs assumed higher bracket rate

Source: Randy Warren • Created with Datawrapper

Tax Rates may rise in the future - with Roth conversion

Item Description	Current Year w Roth Conversion	Future Tax (no min distribution and no tax on Roth)
Gross with $250, convert	$430,000	$40,000 social security only
Taxes Due	$97,320	$5,600
Avg Tax Rate	21%	14%
Marginal Tax Rate	32%	28%

Source: Randy Warren • Created with Datawrapper

We can calculate a reasonable estimate of the number of years it will take for the conversion to make financial sense by dividing the (current cost of conversion)/(future savings of conversion). The cost of conversion is actually higher than this, but our calculation is easier to understand and use for comparison. Therefore, it will take Bob about 6 years (97,320-29400)/(17000-5600) to break even if Bob is correct and tax rates go up significantly in the future. Bob's estimate of future tax rates, with a bracket at 28% means that Bob and his wife will have to live to a minimum of 78 years old to recoup the taxes they pay today to convert. The longer they live past 78, the better the deal looks. But this is ONLY true if the tax rates in the future go up as Bob expected – quite significantly. If tax rates in the future are about the same, or lower, it would take many more years for Bob to recoup the taxes they would pay today to convert from an IRA to a Roth.

Next Step: Making the Decision

Since taxation is very dependent on so many personal factors, it's probably best to talk with Warren Financial and have us mock up some scenarios on your behalf.

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