To Roth Or Not To Roth?

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To Roth Or Not To Roth

- Session Outline
  - Basic technical rules
  - Comparing tax rates & the tax equivalency principle
  - Avoiding RMDs
  - Using outside money and the contribution cap
  - Estate taxes and Roth conversions
  - Q&A

To Roth Or Not To Roth

- Basic Rules:
  - Traditional IRA
    - Potential tax deduction on contribution, tax-deferred growth, taxable withdrawals
    - Deductibility depends on income and whether taxpayer is an active participant
    - Subject to lifetime RMDs
  - Roth IRA
    - Never tax deductible on contribution, tax-deferred growth, potential tax-free withdrawals

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- Basic Rules - Withdrawals:
  - Taxable from IRAs
  - Potentially tax-free from Roth IRAs
    - Principal always withdrawn tax-free
    - Growth potentially tax-free
      - 5 year rule, AND either
      - After 59 ½; due to disability; after death; first-time homebuyer
  - Both subject to 10% early withdrawal penalty unless exception applies

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- Basic Rules - Conversions:
  - Formerly had to have less than $100,000 of modified AGI – repealed
  - Taxable at the time of conversion
    - Premature withdrawal penalties do not apply at conversion
    - Early withdrawal penalties on principal are excluded if held for 5 years after conversion
    - May be recharacterized back to traditional IRA by tax filing deadline (plus extensions)
      - And may be reconverted after the later of the tax year following conversion, or 30days

To Roth Or Not To Roth

- Determining when it is better to use a Roth vs. traditional IRA:
  - Current versus future tax rates
  - Ability to extend deferral of tax-deferred growth
  - Maximum contributions and paying taxes with outside money
  - Estate taxes

To Roth Or Not To Roth

- Current vs. Future tax rates
  - ***Tax equivalency principle***

A certain amount of pre-tax income results in the same amount of after-tax wealth in the end, regardless of which account type it goes to, whenever tax rates remain the same

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- Client has $5,000 of pre-tax income to contribute
- Tax rates are currently 25% and are expected to be 25% in the future
- Contribution may be:
  - $5,000 to Traditional IRA
  - $3,750 to Roth IRA (less 25% in taxes)
- If account doubles and is then withdrawn:
  - Traditional grows to $10,000; worth $7,500 after taxes
  - Roth IRA grows to $7,500
- When tax rates do not change, final account balances are always equal regardless of growth rate – tax equivalency principle!

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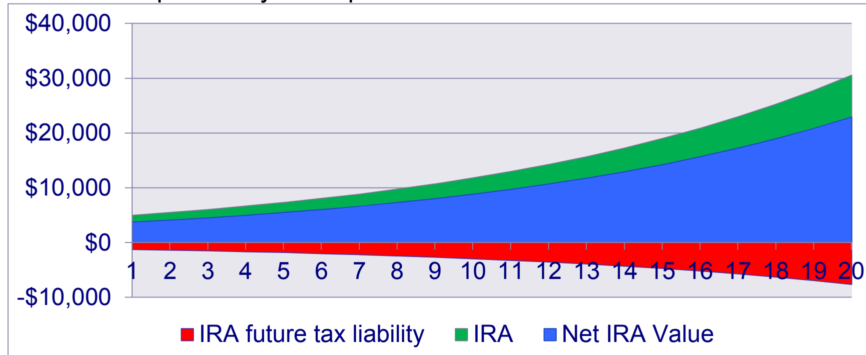
- Tax Equivalency Principle



- Equivalency principle – then what happens when tax rates do change?

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- Current vs. Future tax rates
  - The goal is to pay taxes whenever the tax rate will be lowest
  - If tax rates are lower now than in the future, pay taxes today (Roth IRA)
  - If tax rates are higher now and will be lower in the future, defer taxes to the future (traditional IRA)

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- Contribution under current 25% tax rates:
  - $5,000 to Traditional IRA
  - $3,750 to Roth IRA (less 25% in taxes)

Future tax rate	15%	25%	35%
Traditional 401(k)	$8,500	$7,500	$6,500
Roth 401(k)	$7,500	$7,500	$7,500

- Pay your taxes whenever the tax rate will be lower!

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- What future tax rate will it be?
- Factors in evaluating future tax rates:
  - Withdrawals from pre-tax accounts to support spending or for future RMDs
  - Future pension income
  - Inclusion of Social Security benefits in income
  - Taxable portfolio income
    - Although ordinary income stacks below long-term capital gains and qualified dividends!
  - Acts of Congress

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- Acts of Congress and future tax rates:
  - Higher future taxation – in general – does not necessarily mean a higher tax rate on IRA withdrawals
    - Payroll taxes
    - VAT taxes
    - National sales taxes
    - Exemptions for seniors/retirees
    - More progressive tax bracket structure

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- Additional factor – avoiding RMDs:
  - Relevant only to individuals who live beyond age 70 ½
    - Not relevant past death!
  - Allows dollars to stay in tax-deferred account instead of being forced out into an annually taxable account
  - Greatest value for those who live significantly beyond age 70 ½
  - Allows for slight drop in future tax rates to still benefit Roth 401(k)

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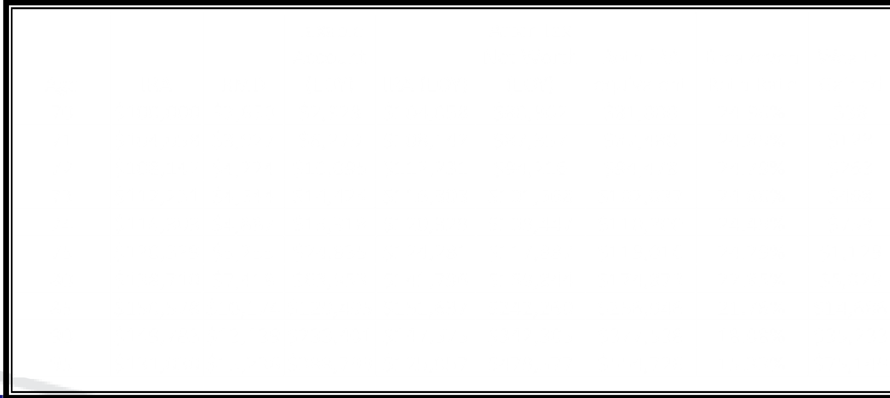
- Additional factor – avoiding RMDs:



  - *Assuming 8% growth and 25% current tax rate

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- Additional factor – maximum contributions:
  - What if an individual wishes to contribute $5,000 to a Roth IRA – which requires $6,667 of pre-tax income (at 25% tax rate)
  - Comparable Traditional IRA contribution of $6,667 is not possible; client would have to contribute $5,000 to IRA and have $1,250 in an after-tax account
  - $5,000 in a Roth IRA grows more favorable than $5,000 in a Traditional IRA and $1,250 in a side account

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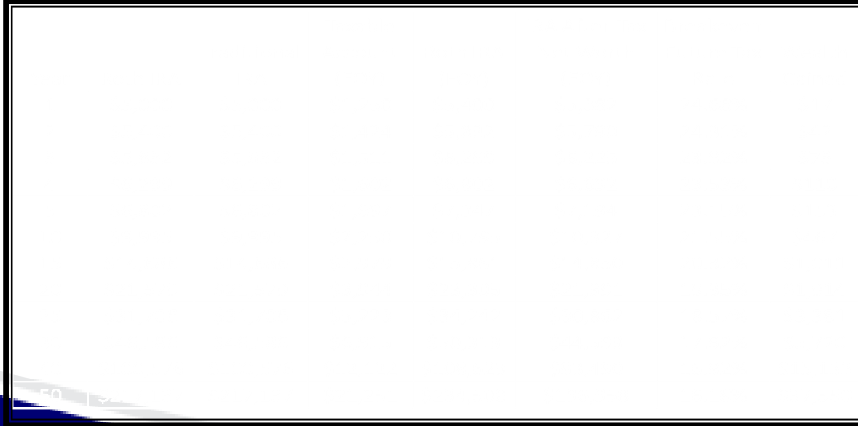
- Traditional vs. Roth IRA over the contribution limit



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- Making maximum contributions
  - Allows higher after-tax contribution by avoiding the embedded tax liability of Traditional IRA contributions
  - Allows for Roth IRA to provide more wealth, even after a modest drop in future tax rates
  - Most advantageous for longer periods of tax deferral
  - Applies for a Roth conversion as well as new contributions

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- Additional factor – estate taxes:
  - Make a Roth contribution – or especially, complete a Roth conversion – as a strategy to reduce the size of the taxable estate
  - By paying the income taxes on the Roth conversion, the gross estate is smaller, theoretically resulting in a lower estate tax liability
  - Does this strategy actually work?

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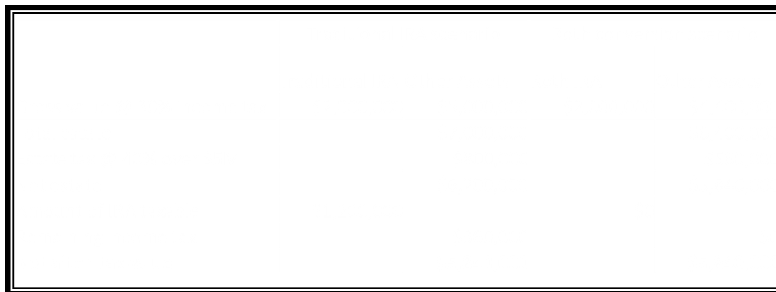
- Additional factor – estate taxes:
  - IRD deduction generally means that Roth conversions do not save Federal estate taxes



  - Exception: If estate is taxable and some of the exemption is allocable to the IRA

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- Additional factor – estate taxes:
  - State estate taxes do not provide an IRD deduction and may result in outright tax savings
    - Estate tax savings must still be balanced against potential future income tax rates
  - Overall, estate tax benefits are greater at the state level, and only relevant at the Federal level for IRA-centric estates with little other assets

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- Legislative risks:
  - New requirement for lifetime RMDs for Roth IRAs?
    - Similar to traditional IRAs
    - Could have exception for small accounts?
  - Loss of post-death stretch (Roth) IRA treatment?
    - 5-year rule unless minor child, close in age, or spousal rollover?

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- Roth vs. traditional IRA summary:
  - Tax equivalency principle means starting point is to focus on current versus future tax rates
  - Pay the tax when the tax rate is anticipated to be lowest
  - Avoiding RMDs allows for a slightly lower future tax rate to still favor the Roth
  - Making maximum contributions and paying taxes with outside money has a similar effect
  - Estate tax impact possible, but client specific

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