

# Advanced Roth Conversion Strategies

11.15.2017 | Schwab IMPACT 2017

## Michael E. Kitces

MSFS, MTAX, CFP®, CLU, ChFC, RHU, REBC, CASL

Partner, Director of Research, Pinnacle Advisory Group

Publisher, The Kitces Report, [www.kitces.com](http://www.kitces.com)

Blogger, Nerd's Eye View, [www.kitces.com/blog](http://www.kitces.com/blog)

Twitterer, @MichaelKitces, [www.twitter.com/MichaelKitces](http://www.twitter.com/MichaelKitces)



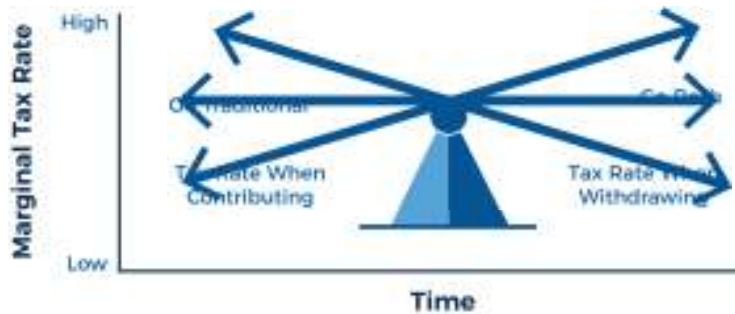
Handouts/Additional Materials at: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)

## To Roth Or Not To Roth

	Traditional IRA	Roth IRA
Contributions	Deductible (Potentially)	Non-Deductible
Growth	Tax-Deferred	Tax-Deferred
Withdrawals	Taxable	Tax-Free (Potentially)
Income Limits	Only for deductibility	Yes
Lifetime RMDs	Yes	No
RMDs After Death	Yes	Yes
Early Withdrawal Penalty	Yes	Yes
Contribution Limit	\$5,500 (+\$1,000 catch-up)	\$5,500 (+\$1,000 catch-up)

## To Roth Or Not To Roth

- Roth vs. traditional IRAs



## 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

## To Roth Or Not To Roth



© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)

@michaelkitces

## To Roth Or Not To Roth

- Tax Equivalency Principle



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

© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)

@michaelkitces

## To Roth Or Not To Roth

- 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%
Tradition 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!

## To Roth Or Not To Roth

- Current vs. Future tax rates
  - Pay your taxes when the tax rate will be lowest!
  - If tax rates are lower now, pay today (Roth IRA)
  - If tax rates are higher now, pay later (Trad. IRA)
- Lesser To-Roth-Or-Not factors
  - Extending tax-deferred growth during life (RMDs)
  - Paying taxes w/ outside money
  - (State) estate taxes

## To Roth Or Not To Roth

- Strategies To Maximize Roth Conversions:
  - Backdoor Roth Contributions
  - Mega Backdoor Roth for 401(k) Plans
  - Systematic Partial Roth Conversions
  - Multiple Account Conversion & Recharacterizations
  - Starting The 5-Year Clock

## “Backdoor” Roth IRA

- “Backdoor” Roth Contribution Rules



## “Backdoor” Roth IRA

- Tax Consequences Of Backdoor Roth Contributions

Non-Deductible IRA Contributions (Non-Traditional) Conversion

1	1	1	1	1	1
2	2	2	2	2	2
3	3	3	3	3	3
4	4	4	4	4	4
5	5	5	5	5	5
6	6	6	6	6	6
7	7	7	7	7	7
8	8	8	8	8	8
9	9	9	9	9	9
10	10	10	10	10	10
11	11	11	11	11	11
12	12	12	12	12	12
13	13	13	13	13	13
14	14	14	14	14	14
15	15	15	15	15	15
16	16	16	16	16	16
17	17	17	17	17	17
18	18	18	18	18	18
19	19	19	19	19	19
20	20	20	20	20	20
21	21	21	21	21	21
22	22	22	22	22	22
23	23	23	23	23	23
24	24	24	24	24	24
25	25	25	25	25	25
26	26	26	26	26	26
27	27	27	27	27	27
28	28	28	28	28	28
29	29	29	29	29	29
30	30	30	30	30	30
31	31	31	31	31	31
32	32	32	32	32	32
33	33	33	33	33	33
34	34	34	34	34	34
35	35	35	35	35	35
36	36	36	36	36	36
37	37	37	37	37	37
38	38	38	38	38	38
39	39	39	39	39	39
40	40	40	40	40	40
41	41	41	41	41	41
42	42	42	42	42	42
43	43	43	43	43	43
44	44	44	44	44	44
45	45	45	45	45	45
46	46	46	46	46	46
47	47	47	47	47	47
48	48	48	48	48	48
49	49	49	49	49	49
50	50	50	50	50	50
51	51	51	51	51	51
52	52	52	52	52	52
53	53	53	53	53	53
54	54	54	54	54	54
55	55	55	55	55	55
56	56	56	56	56	56
57	57	57	57	57	57
58	58	58	58	58	58
59	59	59	59	59	59
60	60	60	60	60	60
61	61	61	61	61	61
62	62	62	62	62	62
63	63	63	63	63	63
64	64	64	64	64	64
65	65	65	65	65	65
66	66	66	66	66	66
67	67	67	67	67	67
68	68	68	68	68	68
69	69	69	69	69	69
70	70	70	70	70	70
71	71	71	71	71	71
72	72	72	72	72	72
73	73	73	73	73	73
74	74	74	74	74	74
75	75	75	75	75	75
76	76	76	76	76	76
77	77	77	77	77	77
78	78	78	78	78	78
79	79	79	79	79	79
80	80	80	80	80	80
81	81	81	81	81	81
82	82	82	82	82	82
83	83	83	83	83	83
84	84	84	84	84	84
85	85	85	85	85	85
86	86	86	86	86	86
87	87	87	87	87	87
88	88	88	88	88	88
89	89	89	89	89	89
90	90	90	90	90	90
91	91	91	91	91	91
92	92	92	92	92	92
93	93	93	93	93	93
94	94	94	94	94	94
95	95	95	95	95	95
96	96	96	96	96	96
97	97	97	97	97	97
98	98	98	98	98	98
99	99	99	99	99	99
100	100	100	100	100	100

## “Backdoor” Roth IRA

- The IRA Aggregation Rule: IRC 408(d)(2)
  - Requires that all IRAs aggregate for tax purposes



- NOT included: Spouse’s IRAs, inherited IRAs, Roth IRAs, or any employer retirement plan

## “Backdoor” Roth IRA

- The Step Transaction Doctrine
  - If separate steps are part of a “single” transaction, the IRS can tax it like a single transaction!



- Unless time passes between the steps!

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)

@michaelkitces

## “Backdoor” Roth IRA

- Avoiding The Step Transaction Doctrine
  - Allow Time To Pass Between The Steps!



© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)

@michaelkitces

## “Backdoor” Roth IRA

- Best Practices In Backdoor Roth Contributions
  1. Avoid the IRA aggregation rule. Roll *in* to a 401(k) plan if necessary (even if you have to create it!).
  2. Avoid the step transaction doctrine by allowing time to pass between contribution & conversion
  3. Don't keep notes in the client file about “backdoor Roth contributions” –can be used against your client!

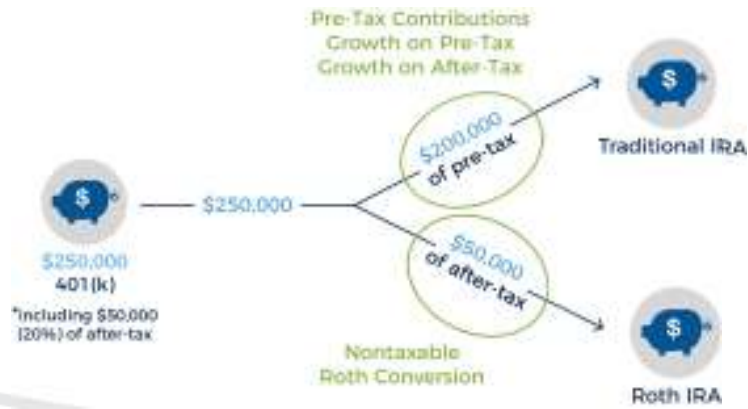
## Mega “Backdoor” Roth IRA!

- From Backdoor Roth to MEGA Backdoor Roth!
  - Converting after-tax dollars not exclusive to IRAs
    - 401(k) plans can have after-tax dollars too!
  - IRS Notice 2014-54 allows after-tax dollars to be split
    - Send the pre-tax to a rollover IRA
    - Send the after-tax to a Roth IRA (conversion)



## Mega "Backdoor" Roth IRA!

- Splitting After-Tax Dollars From A 401(k)



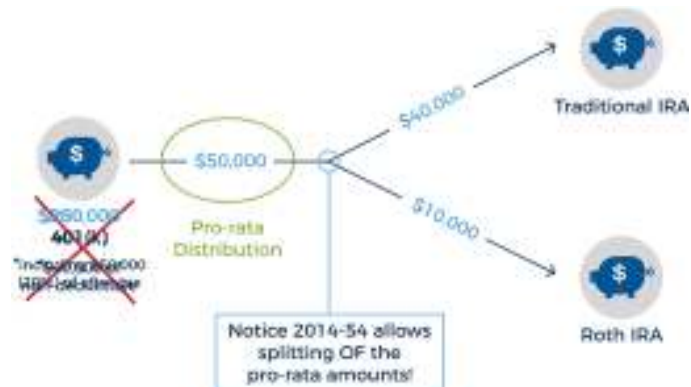
© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)

@michaelkitces

## Mega "Backdoor" Roth IRA!

- Splitting After-Tax Dollars From A 401(k)



© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)

@michaelkitces

## Mega “Backdoor” Roth IRA!

- Maximizing The Mega-Backdoor Roth 401(k)
  - Contribute after-tax dollar amounts (up to 415 limits)
  - Only relevant *after* maxxing out salary deferrals!
  - Must actually have (more) salary to contribute!
  - Plan must allow after-tax contributions
    - Can be added, but watch out for ACP testing
  - Beware that IRS could shut the door!
    - Can do Roth conversions now, if plan allows in-service distributions?

## Mega “Backdoor” Roth IRA!

- Maximizing The Mega-Backdoor Roth 401(k)
  - Hierarchy of Tax-Efficient Retirement Savings
    1. Obtain 401(k) match
    2. Max out 401(k) salary deferral (pre-tax or Roth)
    3. Deferred Roth contributions (after-tax 401(k))
    4. Non-qualified annuities for tax deferral

## Partial Roth Conversions

- Partial Roth Conversions
  - No requirement to be “all or none”
    - Can do *any* dollar amount *up to* 100%!
  - Also have the ability to “recharacterize” a conversion
    - Must be done by October 15<sup>th</sup> of subsequent year
    - Again doesn’t have to be “all or none”
      - Subsequent re-conversions must be later of next tax year, or 30 days later

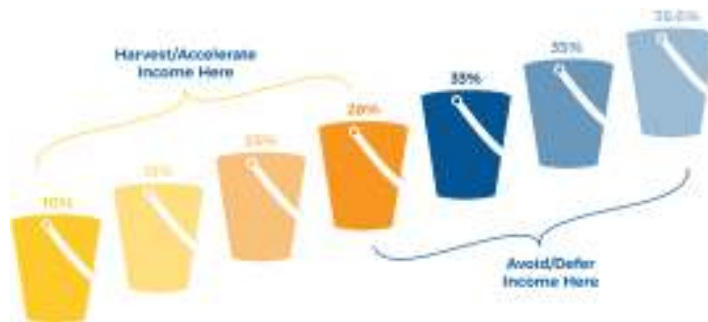
## Partial Roth Conversions

- Partial Roth Conversions & Recharacterizations



## Partial Roth Conversions

- Filling The Lower Tax Bracket Buckets



© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)

 @michaelkitces

## Partial Roth Conversions

- Partial Roth Conversion & Recharacterization
  - Donald & Donna are retired
    - ~\$50,000 of current income
    - ~\$15,000 of deductions
    - Want to fill the 15% bracket (\$75,300)
    - Uncertain about year-end mutual fund distributions
  - Donald & Donna do a \$50,000 Roth conversion now...

© 2013 Michael Kitces | [kitces.com](http://kitces.com)

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)

 @michaelkitces

## Partial Roth Conversions

- Partial Roth Conversion & Recharacterization



© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)



## Partial Roth Conversions

- Systematic Partial Roth Conversions

- Betsy is a 60-year-old widow
  - Receives \$20,000 of Social Security survivor
  - Receives \$40,000 survivorship pension
  - Has \$200,000 brokerage account
  - Has \$700,000 IRA
  - Faces \$50k+ RMDs in 10 years given growth
- Betsy begins to do \$40,000 partial Roth conversions...

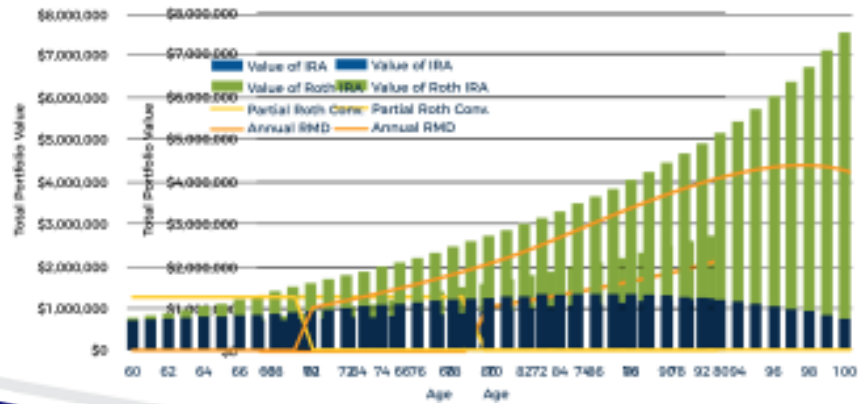
© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)



## Partial Roth Conversions

- Systematic Partial Roth Conversions



© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)



## Partial Roth Conversions

- Spotting Partial Roth Conversion Opportunities

- Low-income years
  - Between jobs/after layoff?
  - Big loss year for a business?
- The valley after employment and before RMDs
  - Can repeat systematically over time?
  - May even be relevant after RMDs begin!?
- Roth conversions while spending from taxable accts?
- Which tax bracket do you want to fill up to?

© 2013 Michael Kitces | kitces.com

Handouts/Materials: [kitces.com/IMPACT17](http://kitces.com/IMPACT17)



## Multi-Account Roth Recharacterizations

- Roth Recharacterization Rules (Redux)
  - Recharacterize by October 15<sup>th</sup> of subsequent year
    - Must include pro-rata share of gains/losses
    - Occurs on an *account by account basis*

## Multi-Account Roth Recharacterizations

- Roth Recharacterization Rules (Redux)
  - Jeremy converted \$50,000 of XYZ stock into his existing \$200,000 IRA
    - Stock crashes by 30% while the rest is up 20%
    - Wants to recharacterize the Roth conversion
  - Account is now up 10% to \$275,000 in total
    - Recharacterization must be for \$55,000!
  - To treat the XYZ stock separately, Jeremy must have converted it *into* a separate account!

## Multi-Account Roth Recharacterizations

- Diversifying Roth Conversions Across Accounts



## Multi-Account Roth Recharacterizations

- Diversifying Roth Conversions Across Accounts
  - Be prepared to create accounts & track them!
  - Need discrete accounts for each investment type or asset class to be segregated
  - Ideally for investments with low/negative correlations
  - Can keep “all the winners” or just up to the tax bucket
    - May need to convert far more than enough to be certain there’s a (best) “winner” to pick?



## 5-Year Rule For Tax-Free Roth

- Satisfying The 5-Year Rule For Tax-Free
  - Roth accounts must meet “5-year rule” to be tax-free
    - In *addition* to being after 59 ½, dead, disabled, or for first-time homebuyer exception
  - Separate from the 5-year rule for Roth *conversions* to be *penalty* free
  - Measured from the beginning of the first year you *ever* created a Roth IRA
    - Roth 401(k)s separate, no carryover to Roth IRAs

## 5-Year Rule For Tax-Free Roth

- Starting The Clock On The 5-Year Rule
  - Make a contribution in *any* year below income limits
    - \$133,000 for individuals, \$196,000 for MFJ
  - Do a (partial) Roth conversion
    - Even if just for \$100 (or \$1,000?)
    - Beware account fees/minimums

## Roth Conversion Opportunities

- Backdoor Roth contributions
  - Siphon off pre-tax dollars to a 401(k)?
  - Waiting period between contribution & conversion
- Mega Backdoor Roth contribution
  - Maximize salary deferral limits first!
  - Add to the 401(k) plan if not already allowed?

## Roth Conversion Opportunities

- Partial Roth Conversions
  - Who is having a low income year to fill up?
  - Systematic conversions for early retirees?
- Multi-Account Roth Conversions
  - Sizable enough to concentrate into multiple accounts?
  - Be ready to track and manage!
- A small conversion for all – start the 5-year clock!

# Questions?

**Handouts & additional materials:**  
[www.kitces.com/IMPACT17](http://www.kitces.com/IMPACT17)

Contact: [questions@kitces.com](mailto:questions@kitces.com)