Advanced Roth Planning: How to Squeeze More Juice Out of the Tax Lemon

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Jeffrey Levine

CPA/PFS, CFP®, CWS®, AIF®, BFA

Advisor. Chief Planning Officer, Buckingham Wealth Partners

Blogger. Lead Financial Planning Nerd, Nerd's Eye View, kitces.com

Educator. Creator, Program Leader, Savvy IRA Planning®

Tweeter. @CPAPlanner, twitter.com/CPAPlanner

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Thought Experiment

- Do we look at Roth Accounts correctly?
- Let's see!!

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Do We Look At Roth Accounts Correctly?

John Doe

- $500,000 mortgage
- $1MM house
- $1MM cash in bank
- $1MM IRA

- Net Worth: $2.5MM?

Jane Doe

- $500,000 mortgage
- $1MM house
- $1MM cash in bank
- $1MM Roth IRA

- Net Worth: $2.5MM?

How do these two clients have the same net worth!?

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Why Roth IRAs?

- No lifetime required minimum distributions
  - Non-spouse beneficiaries do have RMDs
- Tax-free distributions during retirement
- Reduce the number of retirement projection variables
- Tax diversification
- "Tax insurance"

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Roth IRA Conversion Basics

- Pretax portion of conversion is added to client's income in year of conversion
- Conversion year is dictated by when funds *leave* the distributing account
- *For now* - Anyone with an eligible account can convert!
  - No minimum or maximum income
  - No minimum or maximum age
  - No filing status restrictions

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What Can Be Converted to a Roth IRA?

- Traditional IRA accounts
- 401(k) and other qualified accounts
- 403(b) accounts
- SIMPLE IRAs (after two years)
- SEP IRAs
- Governmental 457(b) plans
- Inherited plan assets (to an inherited IRA)

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What Cannot Be Converted to a Roth IRA?

- Inherited IRAs (including inherited SEP IRAs and inherited SIMPLE IRAs)
- SIMPLE IRAs during the first two years
- Non-governmental 457(b) plans

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Targeting Clients for Roth IRA Conversions

- The number one goal of a Roth IRA conversion is to pay income tax when your rate is lowest
  - "Rate" includes, but is not limited to, income tax
- "Obvious" conversion candidates
  - Clients with NOLs
  - Clients with unusually low income/high deductions in a particular year
  - Young clients at start of careers
  - IRAs with high basis
  - Plan accounts with <u>any</u> basis

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IRA Pro-Rata Rule

IRA Pro-Rata Rule*	
Total After-Tax Amounts in ALL Applicable IRAs / Total Balance of ALL Applicable IRAs =	% of Distribution That is Tax-Free

*Exceptions to rule include: QCDs, QHFDs, Rollovers to plans

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Plan Pro-Rata Rule

- **Notice 2014-54**

- Distributions are pro-rata, BUT…the pre-/post-tax portions of the distribution can be "split" and separately allocated
- Any pre-tax portion of a plan distribution must first be allocated to direct rollovers
  - If client has portions of their distribution directly rolled to more than one retirement account (i.e. traditional IRA & Roth IRA), then they can choose how much of the pre-tax funds are allocated to each account
- If total pre-tax portion of a client's distribution is greater than the amount directly rolled over to one or more accounts, any pre-tax amounts are next allocated to 60-day rollovers
- If any pre-tax funds are not rolled over, either via a direct rollover or a 60-day rollover, then those amounts are taxable

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Less Obvious Roth IRA Conversion Candidates

- Those who plan to move to a state with higher income tax
- Those who expect large inheritances that may generate income
- Client(s) that may be hit with the "tax torpedo"

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The "Tax Torpedo" in Action

The Social Security taxation formula gives rise to the so-called "tax-torpedo"

- An increase in the effective marginal rate that's higher – sometimes much higher – than the stated marginal rate
  - Actual rate can be up to 185% of stated marginal rate!
- Caused by the addition of $1 of non-Social Security income leading to an increase in AGI of >$1
- May make Roth conversions more viable, even for those that expect lower (stated) income tax rates during retirement

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The "Tax Torpedo" in Action

- *Scenario #1
  - Non-Social Security income = $38,000
  - Social Security benefits = $25,000
  - AGI = $56,525
  - Taxable Income = $41,825
  - Income tax = $4,819
- Scenario #2
  - Non-Social Security income = $39,000
  - Social Security benefits = $25,000
  - AGI = $58,375
  - Taxable Income = $43,675
  - Income tax = $5,226

Actual increase in income from scenario #1 to scenario #2

$1,000

*Example based on Single filer

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Increase in AGI/Taxable income from scenario #1 to scenario #2

$1,850

$1,850 ÷ $1,000 = $1.85

For every additional dollar of income the client received, an additional $1.85 was added to their AGI and their taxable income!

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Increase in income tax from scenario #1 to scenario #2

$407

$407 ÷ $1,000 = 40.7%

Effective Marginal Tax Rate of 40.7%
vs.
Stated Marginal Tax Rate of 22%

2022 Single Filers	
RATE	Income Between
10%	$0 - $10,275
12%	$10,276 - $41,775
22%	$41,776 - $89,075
24%	$89,076 - $170,050
32%	$170,051 - $215,950
35%	$215,951 - $539,900
37%	$539,900+

Less Obvious Roth IRA Conversion Candidates

- Individuals who may find themselves subject to the "widow's penalty"
  - Similar income, lower brackets
  - Lower thresholds all around
- Clients whose estates may owe state estate tax
  - No IRD or similar deduction for state estate taxes paid
- Clients who may want to access retirement funds before distributions are qualified
  - Roth IRA ordering rules are favorable
  - No 10% penalty on non-qualified distributions upon earlier of attainment of 59 ½ OR more than five years after the conversion

Roth Conversion Planning Post-TCJA

- Roth IRA conversions can no longer be recharacterized
- Eliminates certain strategies
  - Cherry-picking the winners/losers
  - "Old-school" Roth conversion cost averaging
  - Convert now and decide how much to keep later

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Roth Conversion Planning Post-TCJA

- Makes pre-conversion planning MUCH more important
- 3 key steps BEFORE making any Roth conversion
  - Get a ***rough*** estimate of the conversion's potential impact on your client's tax bill
  - Make sure you have a reasonable expectation that the benefits of "pre-paying" taxes via a Roth IRA conversion make sense in the client's overall plan
  - Develop a strategy for paying the additional taxes your client will owe as a result of the conversion

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Roth Conversion Planning Post-TCJA

- In the past, the "best" time to convert was almost always early in the year
- When is the "best" time of year to convert now?
- Converting early in the year allows all future appreciation to occur within the Roth account
- Converting late in the year allows you to more accurately project a client's taxable income

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Roth Conversion Planning Post-TCJA

- There are still strategies savvy advisors can use to maximize Roth IRA conversions:
  - Back-Door Roth IRA
  - "Mega-Back-Door" Roth IRA
  - Filling-up-the-bracket
  - 2022 Roth-conversion-cost-averaging
  - Roth conversion "barbelling"

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Strategy #1
The "Back-Door Roth"

- Strategy for clients who are above their applicable Roth IRA contribution income limit
- Step #1 – Contribute to a traditional IRA
  - No income limit to do so
  - ~~Client cannot be 70 ½ or older by the end of the year~~
  - SECURE Act repealed age restriction for IRA contributions
  - Contributions may not be deductible
- Step #2 – Convert the contribution to a Roth IRA

Caution: Watch out for the pro-rata rule!

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Strategy #2
Mega "Back-Door" Roth IRA!

- From Back-door Roth to MEGA Back-door 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)

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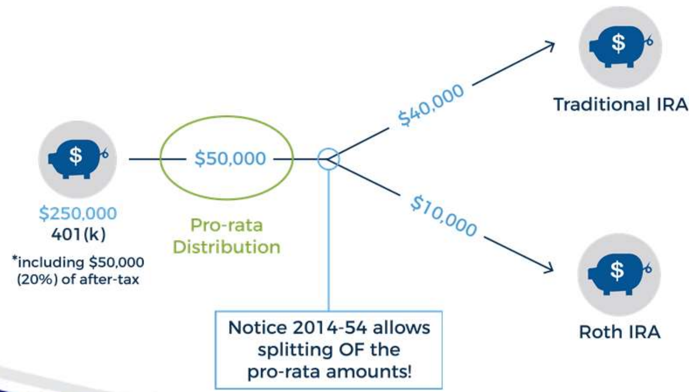
Strategy #2
Mega "Back-Door" Roth IRA!

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



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Strategy #2
Mega "Back-Door" Roth IRA!

- Plan must allow after-tax contributions
- Client must be below the "overall limit" ($61,000 in 2022)
- Client must have disposable income to make after-tax contributions
- The after-tax contributions must pass the actual contribution percentage (ACP) test
- Plan must allow for periodic in-service distributions of after-tax contribution account

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Strategy #3
Filling Up The Bracket

- Convert *just* enough to get to the top of the client's bracket
- Need to be mindful of intra-bracket spikes in rates
  - Phaseouts of deductions, credits, etc.
- Watch out for non-tax "taxes"

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Strategy #4
Roth Conversion-Cost-Averaging

- Step 1: Project your client's taxable income for the year.
- Step 2: Determine how much it would make sense to convert if your client's income is exactly as projected. If the answer here is $0, stop. Do not initiate any conversions yet.
- Step 3: Divide the amount determined in step #2 into monthly, bimonthly, quarterly or other regular interval conversions.
- Step 4: Begin making regular Roth IRA conversions as determined in step #3.
- Step 5: Throughout the year, regularly update your taxable income projections and adjust remaining conversions accordingly.

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Strategy #5
Roth Conversion "Barbelling"

- Step 1: Determine a reasonable range for client's taxable income for the year.
- Step 2: Determine how much it would make sense to convert if the client's income was at the low end of the range. If the answer is $0, stop. A Roth conversion likely does not make sense this year.
- Step 3: Convert the amount that would make sense if the client was on the high end of the income range.
- Step 4: Towards the end of the year, when taxable income can more accurately be forecast, project the client's taxable income again.
- Step 5: Using the results of your analysis from step #4, determine the additional amount that can be tax efficiently converted for the year and complete that conversion before the end of the year (if the client's funds leave the distributing account by December 31, 2022, it will be considered a 2022 conversion, even if the funds don't make it into the Roth IRA until 2023).

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What About In-Plan Roth Conversions?

- A.K.A. In-Plan Roth Rollover (IPRR)
- Roth 401(k) and Roth 403(b)
  - Created by the Economic Growth and Tax Reconciliation Act of 2001
  - Made permanent by the Pension Protection Act of 2006
- Small Business Jobs Act of 2010
  - Created Roth 457(b)
    - Only allowed for governmental 457(b) plans
  - Created In-Plan Roth Conversions
- American Taxpayer Relief Act
  - Eliminated distribution requirement for in-plan conversions

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In-Plan Roth Conversion vs. Roth IRA Conversion

- In-Plan Roth conversion advantages include:
  - Stronger creditor protection *may* be maintained
  - Access to plan loans
  - Fees *may* be more favorable
  - No need to be able to take a distribution from the plan
- In-Plan Roth conversions disadvantages include:
  - DRAs (plan Roth accounts) have RMDs
  - 5-year “clock” doesn’t carry over to Roth IRA after rollover
  - Investment options may be limited

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Life After a Conversion

- Revisit asset allocation strategy
  - Is a rebalance necessary
  - How do you value $100,000 IRA investment in risky asset vs. $100,000 Roth IRA investment in the same asset
- Revisit asset location strategy
  - Should assets be shifted to maximize long-term tax-efficiency
- Revisit retirement spenddown plan
  - Standard thinking is spend from your taxable accounts first and your tax-free accounts last, but that’s not always best!

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