Roth IRA: Complex Conversion Calculations

Chances are, you may know about Roth IRAs and what makes them special. Contributions are made with after-tax dollars. If you convert all or part of a traditional IRA to a Roth, then you pay taxes, at your ordinary income tax rate, on any of the conversion amounts that had not previously been taxed.

Many taxpayers may not be able to make deductible (i.e. pre-tax) contributions to a traditional IRA but can make an after-tax contribution to a traditional IRA (known as a non-deductible contribution). These after-tax contributions will not be taxed again on a Roth conversion (but the earnings would). The advantage to the Roth is that distributions are tax-free, no matter what tax rates do in the future.

There are conversion calculators easily found on the internet to compare the taxes you have to pay now for the conversion versus the taxes you save in the future on withdrawals. A common conclusion from these calculators is if you expect your marginal tax rate to be the same or lower in retirement than it is today, the conversion doesn't make sense.

These calculators often take a too-simplified approach. Why? First of all, because the marginal tax rate is only a part of the story. A taxpayer in the 39.6% marginal bracket isn't really in the 39.6% bracket because he or she is also subject to the 3.8% Medicare surtax, plus the phase-out of itemized deductions plus a higher capital gains rate. So if the analysis is assuming a 39.6% rate in the future, chances are it is understating the actual marginal tax rate by perhaps ten percentage points or more.

The second problem with these analyses is that they ignore the flexibility you get when a portion of your retirement money becomes available tax-free. Common advice says that, in retirement, you should spend down your taxable portfolio and let your traditional and Roth IRA accounts grow tax-deferred. If you don't have a Roth, then your traditional IRA continues to grow until the taxable account runs out.

When you reach age 70 1/2, you have to start taking mandatory distributions from your traditional IRA – and those distribution amounts typically increase each year. It is entirely possible that these distributions could easily throw a taxpayer into a higher marginal tax bracket by their mid-70s, possibly resulting in the loss of itemized deductions, getting hit with the Medicare surtax, and even having higher taxes on their Social Security benefits.

But, if some of your money is set aside in a Roth account, suddenly you have options. For example, in a given retirement year, you take money out of the traditional IRA up to a certain tax rate (say 15% or 25%). This would be an amount before the Medicare surtax or itemized deductions are lost. If you need more income, you could then take the rest out of the Roth without any tax implications. This type of approach gives you control of your tax rate each year. Our experience has been that most taxpayers prefer a consistent tax rate during retirement.

Our point? Determining whether or not to convert some of your IRA into Roth dollars is more complicated than what a naive online calculator would have you believe. It clearly doesn't make sense to make a conversion if it will bump you up from a 25% rate to 39.6% on this year's tax return, and trigger a bunch of stealth taxes.

But somebody in the 25% bracket could make a partial Roth conversion that would use up the rest of the 25% bracket, and perhaps even bump up to the very top of the 28% rate bracket with a larger conversion. Their income would still be below the thresholds for the Medicare surtax and other stealth tax thresholds.

Similarly, if you have fluctuating income, a year when your income is low may represent an opportunity to make a significant Roth conversion -- so you don't waste that lower bracket. You can skip the conversion during years when your income returns to normal (higher) levels.

Yes, these calculations tend to be complicated, but rather than doing nothing, is it not better to be proactive, while you still have flexibility, in making these contribution / conversion decisions? Please let us know if we can help.