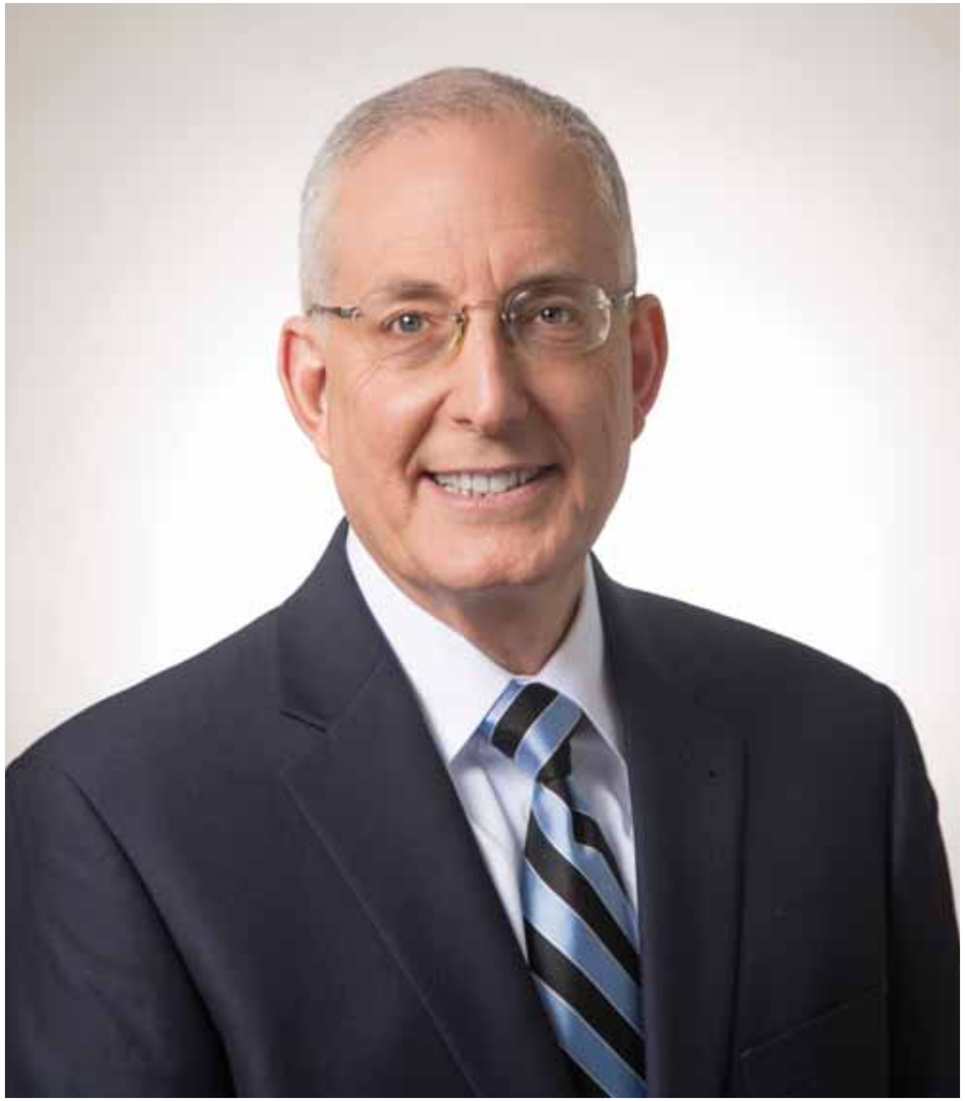
Projecting the Tax on a Roth Conversion

Webinar with Ed Slott | November 21, 2019



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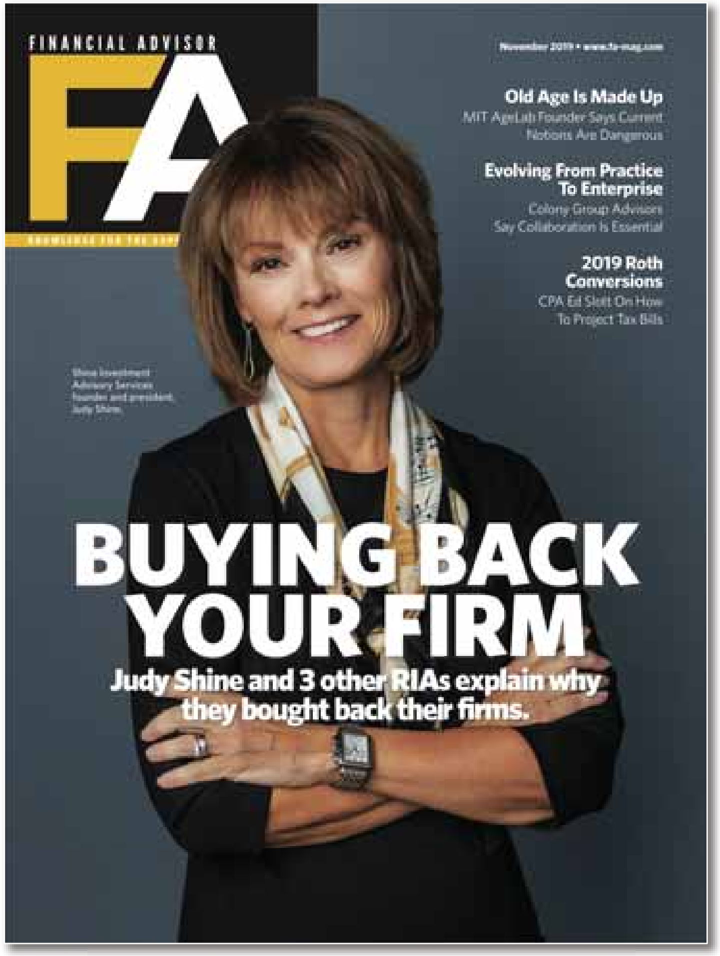

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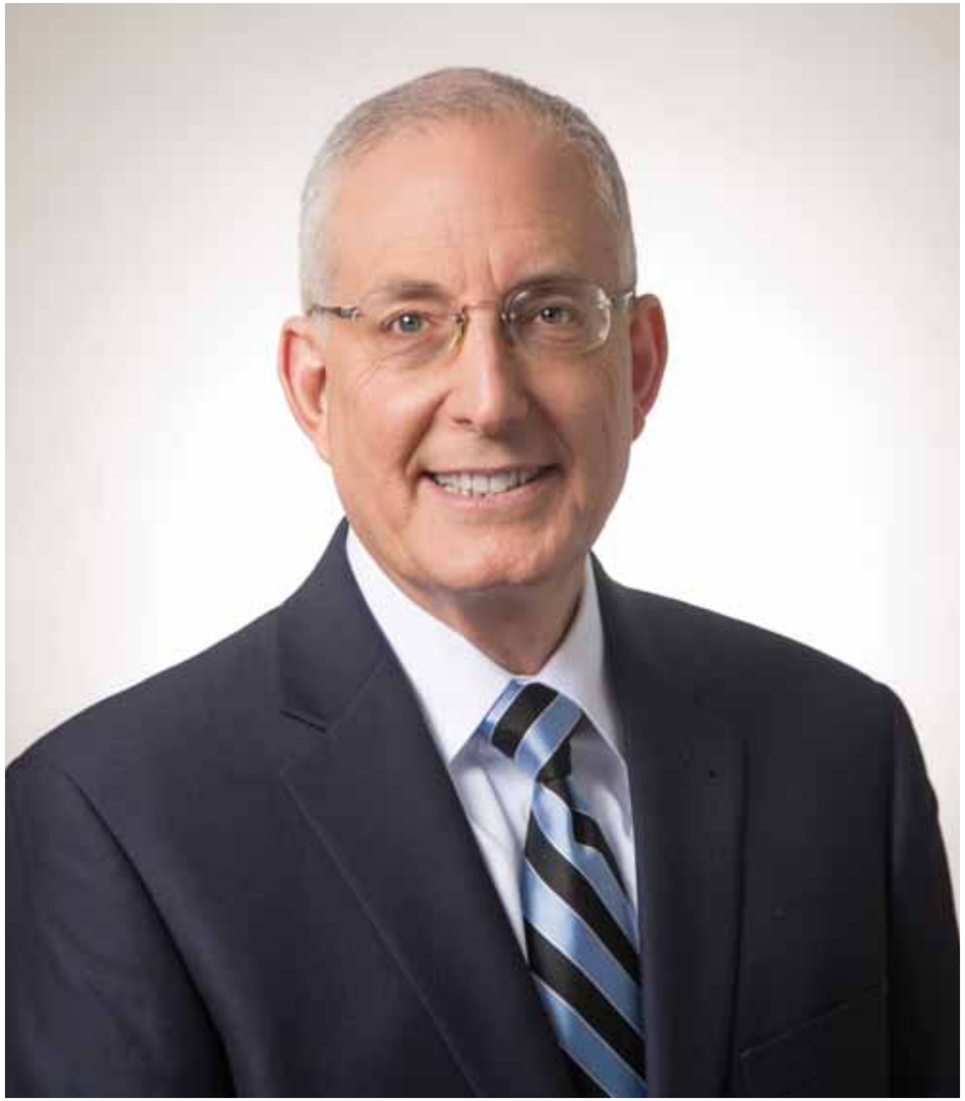


What will a 2019 Roth conversion cost?

Avoid Surprises at Tax Time Next Year

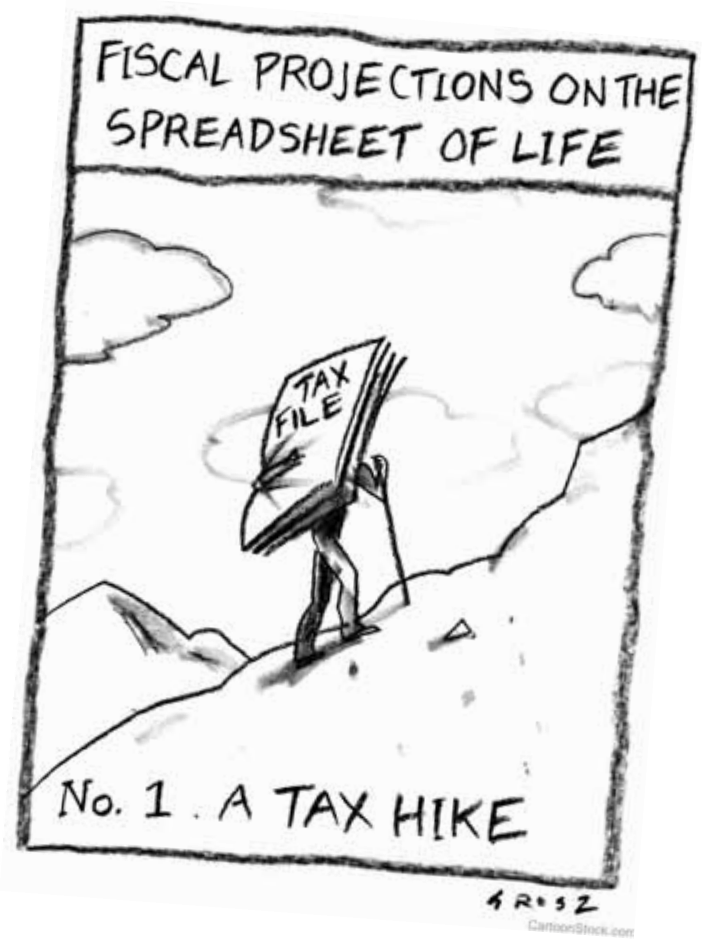
- **Roth conversions cannot be undone!**

The ***Tax Cuts and Jobs Act*** eliminated Roth conversion recharacterizations – so the tax will be owed.

- **Critical Issue:**

How much will the Roth conversion cost in taxes?

An accurate tax projection will be essential ***before*** going ahead with any Roth conversion.



Benefits of a Roth Conversion

▲ **Roth IRA distributions can be withdrawn tax-free**

- Tax free income in retirement keeps your taxable income low, even if tax rates increase.
- Your Roth IRA will compound income tax free, for beneficiaries, too.

▲ **Qualified distributions are tax free**

- Held for 5 years since first Roth conversion or contribution, ***AND***
- Age 59½, ***OR***
- Disabled, ***OR***
- Death (paid to a beneficiary), ***OR***
- First-Time homebuyer – *Up to a $10,000 lifetime limit*

Benefits of a Roth Conversion

- **If future tax rates increase, tax-free Roth IRA income will be more valuable.**

- **Roth IRAs remove the uncertainty of what your future tax rates might be.**

- **RMD Benefit – Roth IRAs have *NO RMDs during lifetime.***
  - Also, there are no RMDs for a spouse who moves inherited Roth IRA funds over to his/her own Roth IRA (a spousal rollover).

  - A younger or surviving spouse can extend the time that Roth funds are not subject to RMDs.

Benefits of a Roth Conversion

Roth conversions can avoid high trust taxes

2019 Trust Tax Rates

10%	$ 0 – $2,600
24%	$2,601 – $9,300
35%	$9,301 – $12,750
37%	Over $12,750

▲ **If a trust is the IRA beneficiary, a Roth IRA conversion can eliminate trust taxes for heirs:**

- Post-death RMDs to the trust are tax free, even if held in the trust.

▲ **Roth IRAs left to young children can avoid the "kiddie tax" at trust rates.**

Opportunity Cost Argument

Opportunity Cost Argument

- This argument ***does not hold up!***

The opportunity cost argument:

- The funds used to pay the conversion tax could have been otherwise invested, and that investment return opportunity is lost.

▼ **Not True!**

It's all about the Tax Rates

- There is **NO** opportunity cost in terms of lost investment gains ***if the tax rates are the same*** both at conversion and later at distribution.

Opportunity Cost Argument

Excerpt from: ***The Wall Street Journal* (May 31, 2019)**
"Wow Did We Get a Lot of Questions About the Roth 401(k)"
By Laura Saunders

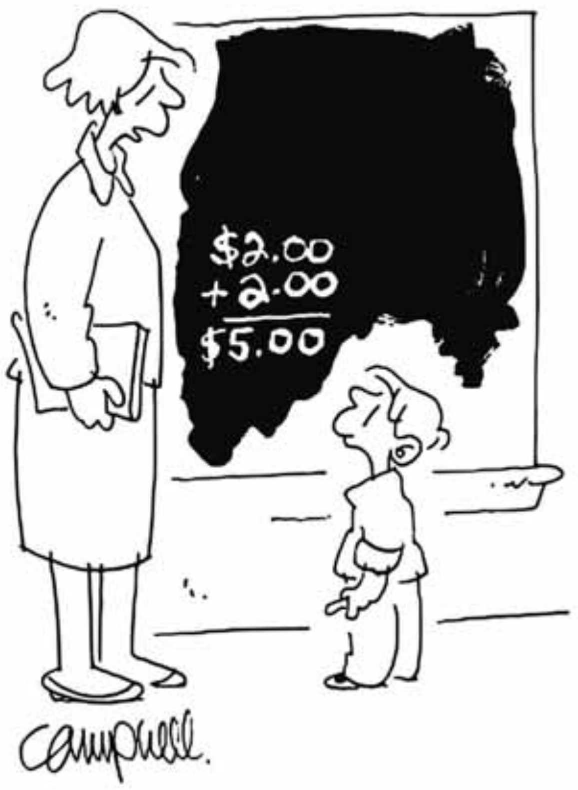
So Roth savings can cost more up front.
How do I know if they're worth it for me?
The main consideration, says Vanguard Group's Global Head of Enterprise Advice Methodology, Joel Dickson, is the saver's top federal and state tax rate on the money going in compared with this rate at withdrawal. If it will be higher later on, opting for a Roth is probably better.

Choosing a Roth may even be better if the tax rate will be the same or lower in some cases, according to Vanguard's research.

What about other factors, like the length of time the money invested, or inflation, or investment asset class? Do these affect the decision to go Roth?
Mr. Dickson is insistent: **These facts make "not an iota of difference."**

Opportunity Cost Argument

This is not well understood but the math is clear. *It's all about the tax rates.*



"It's not an accounting breakthrough, Sam. It's wrong."

► ***If tax rates (and earnings) are the same, the net after-tax result will be the same*** whether the IRA funds stay in the traditional IRA or are converted to a Roth IRA.

Opportunity Cost Argument

Example:

Assumptions

- $100,000 Traditional IRA Balance
- Lifetime investment return = 200%
- Lifetime tax rate = 30%

No Roth Conversion

- Traditional IRA balance after lifetime earnings of 200% = $300,000

Net after-tax at 30% tax rate = **$210,000**

Roth Conversion

- $100,000 after paying a 30% tax on the conversion = $70,000

Roth IRA balance after lifetime earnings of 200% = **$210,000**
($70,000 after a 200% return = $210,000)

Side Effects of Roth Conversions

▼ Roth conversions increase adjusted gross income (AGI).

▼ Added Roth conversion income triggers stealth taxes and loss of tax benefits that get phased out including itemized deductions, credits and other tax benefits based on AGI, ***but that only happens in the year of the Roth conversion.***

- Tax on Social Security
- Medicare Part B and D premiums - IRMAA Charges
- 20% qualified business income deduction
- 3.8% tax on Net Investment Income
- Financial aid eligibility + other education-related tax benefits
- Medical deductions – *must exceed 10% of AGI* – New for 2019
- Real estate losses

How to Avoid Wasting Valuable Tax Deductions

Wasted Tax Deductions

▼ Roth conversions will reduce or eliminate the balance in traditional IRAs, so future deductions, losses or lower brackets might be wasted.

- ***Don't convert if IRA funds will be needed to fund upcoming expenses.*** (e.g. high medical expenses, business losses, QCDs)

▼ The tax benefit of medical deductions (if itemizing) could be lost if there is no other taxable income to absorb those deductions.

- IRA distributions increase income, which increases the medical deduction limitation (10% for 2019).

▼ RMD income and other taxable IRA distributions may be offset with these deductions.

How to Avoid Wasting Valuable Tax Deductions

For those IRA owners (or IRA beneficiaries) who are age 70½ or older:

► **Qualified Charitable Distributions (QCDs)**

- QCDs are excluded from income
- QCDs can lower or eliminate the tax on RMDs

A Roth conversion may not be needed if traditional IRA distributions can be excluded from income over time with QCDs and other deductions.

Projecting the *Tax Cost* of a *Roth Conversion*

"I say we should go with plan 'A', sir."

Projecting the Tax Cost of a Roth Conversion

Taxable Income Brackets for 2019 *Ordinary* Income Tax Rates

Marginal Tax Rates	Married Filing Jointly	Single
10%	$0 – $19,400	$0 – $9,700
12%	$19,401 – $78,950	$9,701 – $39,475
22%	$78,951 – $168,400	$39,476 – $84,200
24%	$168,401 – $321,450	$84,201 – $160,725
32%	$321,451 – $408,200	$160,726 – $204,100
35%	$408,201 – $612,350	$204,101 – $510,300
37% *	Over $612,350	Over $510,300

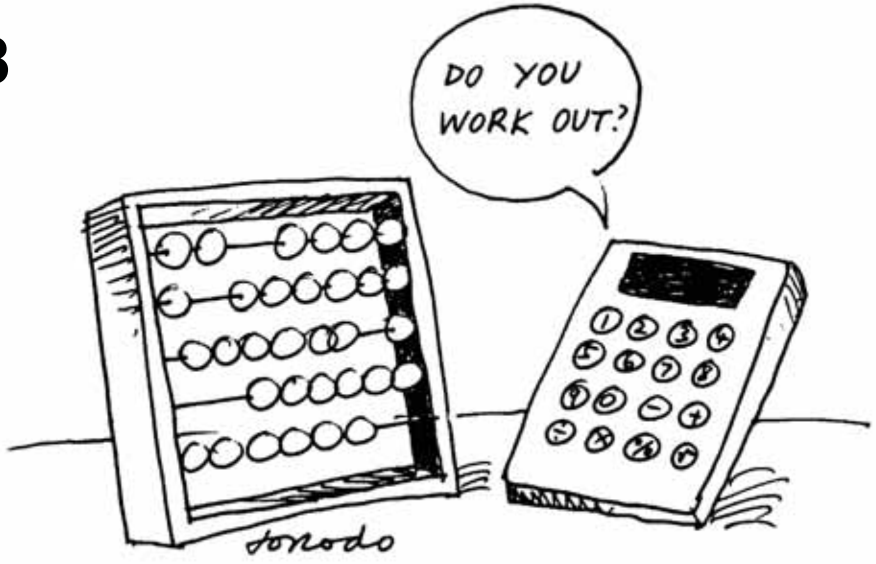
* *The top rate is effectively 40.8% for those subject to the 3.8% Medicare surtax on net investment income*

Projecting the Tax Cost of a Roth Conversion

► **An accurate tax projection is critical**

- The Roth conversion ***cannot be undone.***
- The tax will be owed, plus the additional (stealth) taxes that could be owed by increasing adjusted gross income.

► **Start the tax projection process by using the 2018 tax return for comparison (consult with the CPA or other tax preparer on this).**



Projecting the Tax Cost of a Roth Conversion

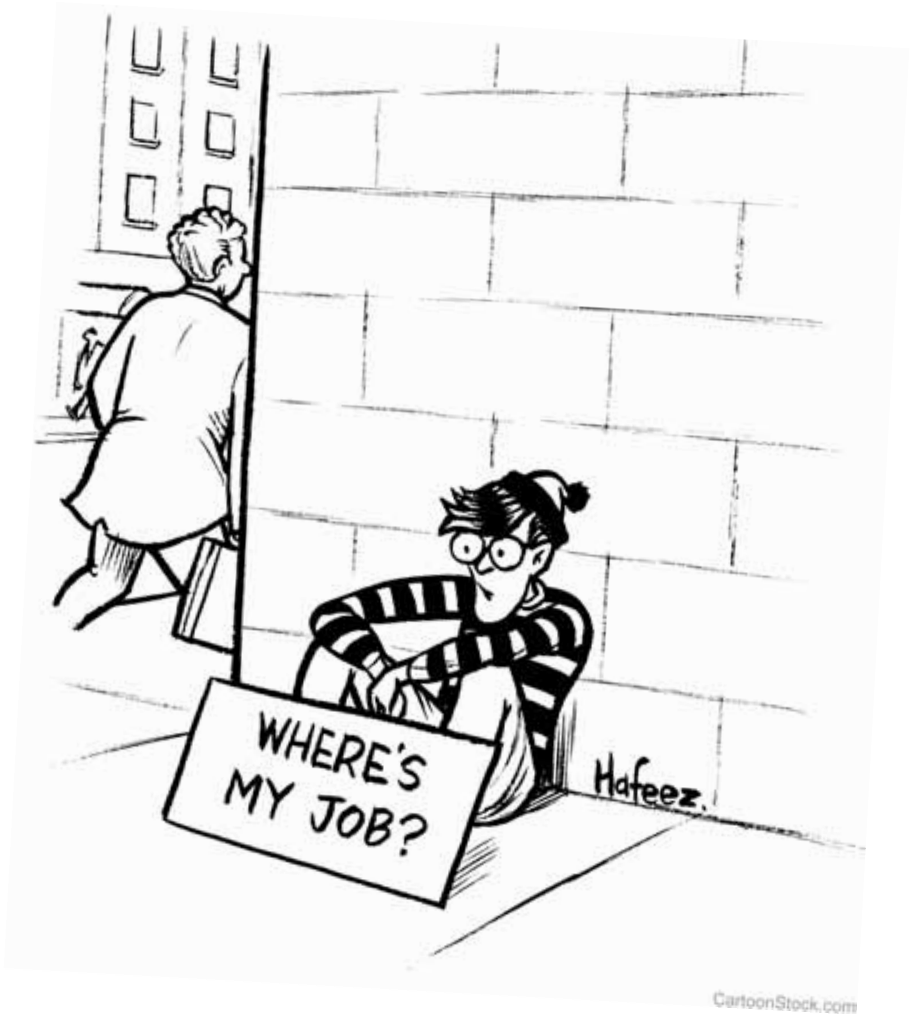
► **Make adjustments for items that changed in 2019**

- **Ask about *spikes* in 2019 income or other deductions**
  - Additional wages, bonus or other business income
  - Large pension payouts or IRA distributions
    - Beginning RMDs or RMDs on inherited IRAs
  - Business Income / Business losses
    - Including depreciation on assets acquired
  - Medical deductions
  - Investment income – *large gains or losses*
  - Gifts or inheritances received – *added investment income*
  - Gains from property sales
  - Casualty losses – *if deductible* (only in a federal disaster area)
  - Large charitable gifts
  - Windfalls (e.g. lottery or gambling gains)

Projecting the Tax Cost of a Roth Conversion

► **Make adjustments for items that changed in 2019 (continued)**

- **Ask about changes in family or tax status**
  - Change in filing status – *divorce or death of spouse*
  - Change in family – *change in dependents*
- **Address any tax law changes**
  - e.g. The SECURE Act



Projecting the Tax Cost of a Roth Conversion

5 most misunderstood tax effects of a Roth conversion

1. Capital Gains (Long-Term Capital Gains)
2. 20% Qualified Business Income (QBI) Deduction
3. Medicare Charges
   Income Related Monthly Adjustment Amount (IRMAA)
4. Child Tax Credit Effect
5. Alimony
   New for 2019: No deduction for payor; tax free to the recipient

1. Capital Gains

2019 Long Term Capital Gains (LTCG) and Qualified Dividends Tax

LTCG Rate	Married Filing Jointly	Single
0%	$0 – $78,750	$0 – $39,375
15% *	$78,751 – $488,850	$39,376 – $434,550
20% * *	Over $488,850	Over $434,550

**Those in the 15% LTCG tax bracket with MAGI over their 3.8% threshold ($250,000 joint filers/$200,000 single filers) will pay an effective rate of 18.8%*

** * The top rate is effectively 23.8% for those subject to the 3.8% Medicare surtax on net investment income*

Taxation Principle:

Ordinary income is taxed first – using up the lower capital gains brackets

1. Capital Gains

Simplified Example:

Married-Joint couple has no income other than a $100,000 LTCG.

Total tax = -0-

LTCG	$100,000
Less: Standard Deduction (under age 65)	(24,400)
Net taxable LTCG	$ 75,600
Tax due	-0-

-0-% LTCG bracket goes up to $78,750

1. Capital Gains

Now let's add a $50,000 Roth conversion:
Tax on LTCG is increased from -0- to $7,028.
The tax on the Roth conversion is only $2,684, but the total tax bill will be $9,712.

Roth conversion income (ordinary income)	$ 50,000
Less: Standard Deduction (under age 65)	(24,400)
Amount of LTCG bracket used up	**$ 25,600**

The $25,600 is taxed using the regular tax brackets, so that tax is $2,684

$ 19,400	at 10% =	$ 1,940
6,200	at 12% =	744
$ 25,600		$ 2,684

1. Capital Gains

LTCG Tax goes from -0- to $7,028

The benefit of the -0- to $78,750 LTCG bracket is reduced by the $25,600, which was taxed at ordinary income tax rates.

Only $53,150 is being taxed at -0-%
(the $78,750 less the $25,600 = $53,150)

The remaining $46,850 of the $100,000 LTCG is now being pushed into the 15% LTCG bracket and the tax on that $46,850 x15% = $7,028.

$ 53,150	at	-0-%	=	$ -0-
46,850	at	15%	=	7,028
$100,000				$ 7,028

1. Capital Gains

Change the Roth conversion to $120,000
LTCG tax goes from -0- to $15,000!

All taxed at the 15% bracket
The entire -0-% LTCG bracket is lost – *Roth conversion income ate that up*

Roth conversion	$120,000
Less: Standard Deduction (under age 65)	(24,400)
Taxable Roth conversion income	$ 95,600

1. Capital Gains

<Continued>

The $95,600 (net Roth conversion income - after the standard deduction) is taxed using the regular tax brackets, so that tax is $12,749.

$ 19,400	at 10% =	$ 1,940
59,550	at 12% =	7,146
16,650	at 22% =	3,663
$ 95,600		$ 12,749

The benefit of the -0- to $78,750 zero LTCG bracket is eliminated by the $95,600 which was taxed at ordinary income tax rates.

1. Capital Gains

The entire $100,000 LTCG will be taxed at 15%, with no benefit of the -0-% tax bracket.

"Money from the Tooth Fairy, eh? Don't forget to declare capital gains!"

$ -0-	at 0%	=	$ -0-
100,000	at 15%	=	15,000
$ 100,000			$ 15,000

Tax Recap after a $120,000 Roth conversion

Roth conversion tax	=	$ 12,749
LTCG tax	=	15,000
Total Tax	=	$ 27,749

2. 20% QBI (Qualified Business Income) Deduction

Section 199A Deduction

- First appeared on 2018 tax returns

The 2019 QBI Taxable Income Limits

- $321,400 to $421,400 for married filing jointly
- $160,700 to $210,700 for single filers

▲ Clients Affected:

Most small business clients with pass-through income (from LLCs, S Corps., partnerships and sole proprietorships) fall under these limits so they all receive the 20% tax deduction.

2. 20% QBI (Qualified Business Income) Deduction

Section 199A Deduction

Roth Conversion Effect:

- Roth conversion can cause the deduction to be **decreased** or **increased**
- A Roth conversion can push taxable income over the QBI limits and cause the 20% deduction to be lost.
- A Roth conversion can also ***increase*** the QBI deduction.
  - The deduction in general is 20% of business income from any of these pass-through entities, if it doesn't exceed the QBI limits.
  - QBI deduction is reduced if taxable income (in excess of capital gains) is less than QBI.
  - In this case, a Roth conversion can increase taxable income and in turn increase the QBI deduction.

2. 20% QBI (Qualified Business Income) Deduction

Section 199A Deduction

Warning!

- You must be careful not to convert so much that it throws income over the limit where the deduction can be lost altogether. This is a delicate balancing act.

- Once income exceeds the QBI limits, other complex tax rules apply including the type of business, W-2 and capital investment tests which can knock out or allow the 20% tax deduction.

- If the client already does not qualify for the QBI deduction, due to the type of business or level of income, then the Roth conversion will have no effect since the deduction was lost even before the conversion.

3. Medicare IRMAA Charges
Income Related Monthly Adjustment Amount

2-Year Lookback Rule – makes Roth conversion planning more challenging

2019 Change: New IRMAA charge income bracket was added for higher income Medicare enrollees:
- $500,000 and above for Singles
- $750,000 and above for Married-Joint

IRMAA charges are based on income from two years ago
(MAGI - includes tax-exempt interest and untaxed foreign income).

3. Medicare IRMAA Charges
Income Related Monthly Adjustment Amount

The 2019 limits apply to 2017 income which already happened.

- A Roth conversion in 2019 won't impact the IRMAA charges until 2021.
- You will need to plan two years ahead to see how a 2019 Roth conversion (along with other 2019 income) will impact IRMAA charges in 2021.

4. Child Tax Credit Effect

Personal exemptions are eliminated (since 2018) and replaced with new child tax credits

- A tax credit is more valuable than a tax deduction since the tax credit reduces the tax, dollar for dollar.

► How will your clients fare on the "net" difference?

Will the tax credit cut the tax bill more than the personal exemptions did?

- Some children won't qualify

The credit is $2,000 per qualifying child – *under age 17*

- Subject to income limits ($400,000 joint, and $200,000 for all others)
- The tax credit for children ages 17+ and other dependents is only $500

4. Child Tax Credit Effect

The child tax credit can reduce the tax on a Roth conversion

- Unless the conversion is so large that it pushes income over the limits.

Review the completed 2018 tax return:

- Determine the impact of children and other dependents on a 2019 Roth conversion

- Also, note any changes:
  - A child who turned 17 and no longer qualifies for the $2,000 credit
  - A child who is no longer a dependent
  - Divorce agreement that may now allow (or take away) a child tax credit
  - Income increase that could disqualify the credit

4. Child Tax Credit Effect

Kiddie Tax Effect:

- A child's unearned income will no longer affect the parent's tax return.
  - The child will pay the tax, if applicable, on his own tax return at trust and estate tax rates.
  - It will be a bit easier to project the tax on a Roth conversion for parents who no longer must include the child's income on their tax returns.
  - This change might lower the tax bill on conversions for these parents.

5. Alimony

New for 2019: No deduction, but tax free to the recipient

Beginning for 2019 divorces, alimony is no longer deductible, and alimony received is no longer taxable income.

- Pre-2019 alimony deals are not subject to these new rules, unless they opt in.

How alimony can affect Roth conversions:

- The client paying the alimony cannot count on the alimony tax deduction to offset Roth conversion income
- The spouse receiving alimony income might be able to convert more since the alimony income won't be taxable.
- Limited application since 2019 was the first year for this change
    - This will only affect those clients divorced in 2019, and those who elected to have the new rules apply to their pre-2019 arrangement.

Recap

✓ ***5 most misunderstood tax effects of a Roth conversion***

1. **Capital Gains (Long-Term Capital Gains)**
2. **20% QBI (Qualified Business Income) Deduction**
3. **Medicare Charges**
   Income Related Monthly Adjustment Amount (IRMAA)
4. **Child Tax Credit Effect**
5. **Alimony**
   New for 2019: No deduction, but tax free to the recipient

Advisor Recommendations

- ✓ **Remind clients that Roth conversions *cannot be undone* – they are final and the tax will be owed!**
- ✓ **Evaluate Roth conversions later in the year – After Thanksgiving, when income can be better projected for the year.**
  - ✓ Don't wait too long though because the funds must leave the traditional IRA by December 31 for a 2019 conversion
- ✓ **Take new items of income or deductions into account**
  - ✓ Spikes and other items that did not occur in the previous year
- ✓ **Consider partial conversions**
  - ✓ A series of smaller annual conversions over time, taking advantage of lower tax brackets

Advisor Recommendations

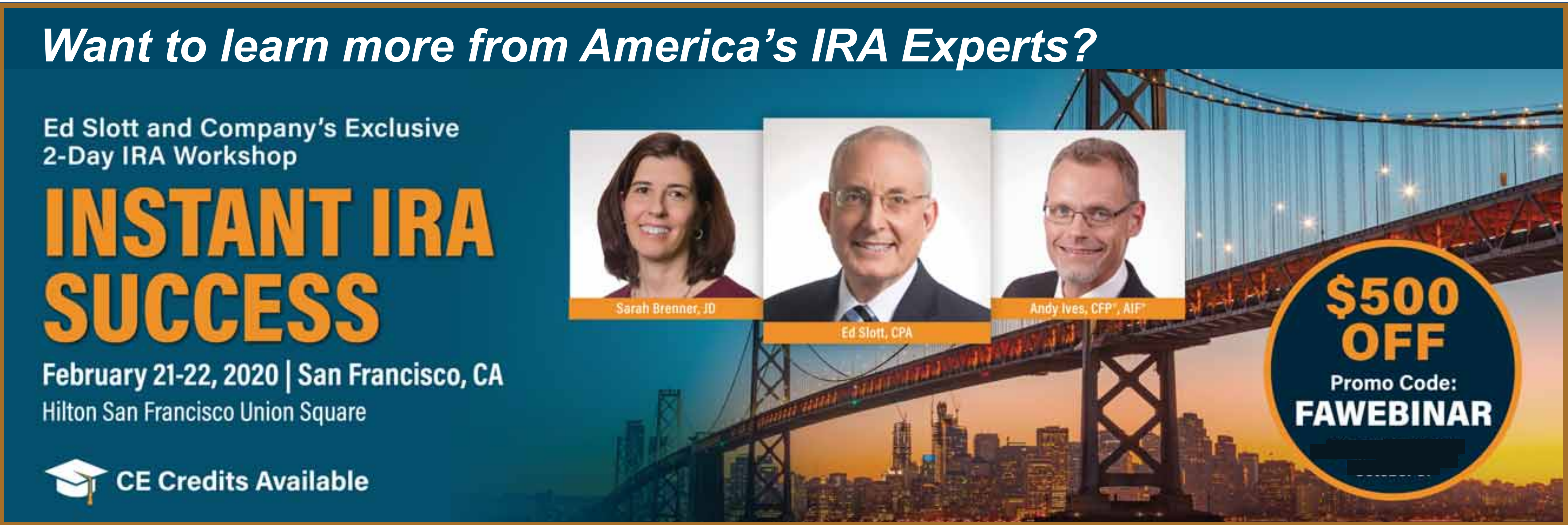
- ✓ **Consider converting before reaching the year clients reach age 70½, since RMDs must begin in that year and RMDs cannot be converted.**
- ✓ **Consider having clients convert to use up deductions (examples – medical deductions, business losses) or convert enough to use up lower tax brackets.**
- ✓ **Consider having clients convert if the market declines – *to take advantage of lower values, reducing the tax cost of the conversion.***
- ✓ **Advise clients not to use the converted funds to pay the tax**
  - ✓ This will generally not pay and could incur a 10% penalty in addition to income tax on any funds withdrawn and not converted.
- ✓ **Advise clients not to convert if it appears that future tax rates for them or their beneficiaries may be lower.**

The Roth IRA Tax Projection is a High-Value Conversation!

- It is unique and personal to each client
- It requires advanced tax planning knowledge
- It is not being done effectively by financial or tax advisors

Contact your clients *NOW!*

Show your clients that you have their back and you are a pro-active advisor. Alert them to how the SECURE ACT may potentially affect their retirement and their beneficiaries. ***This is a great opportunity to connect with families.***



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