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Dueling Approaches To Roth Conversions

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For years, financial and tax advisors have counseled their clients to make Roth conversions when it's expedient, but not to convert so much that it pushes the clients into a higher federal income tax bracket. After the SECURE Act, does this strategy always still make sense?

Take, for example, this scenario: A couple, both age 65 and recently retired, have accumulated a combined $2 million in taxable IRAs. They are expecting no other significant sources of retirement income other than Social Security at $60,000 per year. The couple estimates their current life expectancy at 20 years.

If you consider the likelihood that individual income tax rates will rise in the year 2026, if not earlier, you might tell this couple to withdraw taxable IRA funds earlier and to a greater extent than required by the tax law, and then roll it (after tax) either into a nontaxable Roth IRA, to the extent the amount withdrawn exceeds the required minimum distribution amount for the year, or into some other form of no-tax investments (such as life insurance or municipal bonds). This can no doubt be a sound income tax planning strategy.

But what is the optimum annual amount to withdraw from the taxable IRA? There are two basic alternatives: the so-called "tax table approach," where the focus is helping the couple avoid being pushed into a significantly higher current income tax bracket, or the so-called "amortization table approach," which ignores current income tax brackets and instead focuses of lowering the total income tax liability of both the couple and their children after the spouses' deaths.

Under the tax table approach, the couple may choose to withdraw $80,250 per year (or about 4% of the initial IRA value) for the first seven years, because this will keep them in the 12% federal income tax bracket for 2020, and out of the 22% bracket. (For the purposes of this article, we assume the taxable portion of the Social Security uses up the couple's standard deduction amount, but no more, and that their itemized deductions do not exceed their standard deduction amount.) After age 72, the couple will be forced to take a larger amount under required minimum distribution rules. The federal income tax on the withdrawal during the first seven years would be $9,235 per year, or $64,645 over the seven-year period (if we assume that the tax rates will not change and the couple is able to file jointly the entire period).

If we assume that there's a 5% growth rate, the couple's taxable IRAs would be worth approximately $2.2 million after year seven. The total tax on the RMDs from year eight through year 20 would be $215,343, which, when added to the $64,645, would mean a total tax on the RMDs of $279,987 during the couple's estimated 20-year life expectancy.

Under the amortization table approach, the couple would instead add their 20-year estimated life expectancy to the 10-year maximum period over which the couple's children must withdraw the rest of the taxable IRAs after the couple's death, and "amortize" their taxable IRAs over 30 years. If we assume the growth rate is 5%, we would take the same withdrawals every year at $128,837. The federal income tax on this larger amount would be $19,923 per year, or $398,478 over the couple's estimated 20-year life expectancy (again under unchanging tax rates with joint filing the entire time, and assuming that the taxable portion of the couple's Social Security uses up their standard deduction, but no more, and that their itemized deductions do not exceed their standard deduction amount). The couple thus pays $118,491 more in income taxes under the amortization table approach than they would under the tax table approach ($398,478 instead of $279,987).

Under the amortization table approach, the amount remaining in the taxable IRA at the couple's projected death in 20 years would be approximately $1 million; under the tax table approach, the amount remaining in the taxable IRA in 20 years would be approximately $2.2 million.

Now we need to compute the approximate annual withdrawal amount for the children after the couple pass on, using the same two approaches and assuming there will be equal annual withdrawals over 10 years and a 5% growth rate in the accounts. These withdrawals would be a consistent $127,279 per year under the 30-year amortization table approach (on a base of approximately $1 million). Under the tax table approach, these annual withdrawals would be $280,013 (starting on the $2.2 million base).

If we assume the couple has one child, and that this child's annual taxable income, excluding the IRA payments, is $150,000, the child's total annual taxable income during the 10-year payout period would be $277,279 under the amortization table approach and $430,013 under the tax table strategy.

Using 2020 tax tables and assuming that the child's tax status is married and filing jointly (and ignoring for this purpose any potential tax on Social Security payments), we find the child's annual tax liability would be $54,706 under the amortization table approach (or $547,060 over 10 years) and $100,094 under the tax table approach (or $1,000,940 over 10 years)—a difference of $453,880 over the decade. (Assume, for the purpose of this analysis, that the married couple has other income equaling their standard deduction, and that their itemized deductions do not exceed their standard deduction amount.)

Again, we must consider that the couple who owned the IRAs would be paying $118,491 less in lifetime taxes under the tax table method, so we take that out of the $453,880 advantage of using the amortization table strategy and come up with a net tax savings of $335,389 when we're looking over the entire 30 years. The tax savings could be even higher if the child were in a higher income tax bracket.

But even if the tax savings will be more under the tax amortization table approach, it does not reflect the lost time value of the $118,491 the couple will pay in additional taxes during their lifetime. However, this potential loss must be balanced against the likelihood that one of the spouses will die before the other, perhaps several years before. Before that happens, the spouses together are facing a tax bracket that is essentially half that of the widow or widower, and these two competing factors essentially cancel each other out. Also, remember that tax rates can rise in the future, so withdrawing a larger amount earlier may also be beneficial from this perspective.

The numbers can obviously be run a variety of ways, and of course there are countless different client fact patterns presented to us as advisors. The purpose of this article is simply to show that traditional Roth conversion strategies need to be challenged in light of the SECURE Act to ensure that our clients are not forgoing a significant potential family income tax savings by not exploring all of the Roth conversion approaches available to them.

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