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# The Limits Of Roth IRAs For The Wealthy

**DECEMBER 28, 2020 • JAMES G. BLASE**

*The following is a book review of "*ROTHS FOR THE RICH: How to Fund Your Roth With Over $100,000 Each Year,*" by Will Duffy.*

Roth IRAs have long been a viable tax planning tool for advisors working with affluent clients. The prospect of higher taxes on high-earning Americans, coupled with the death of stretch IRAs, has rekindled interest in these vehicles. In his recently published book, "ROTHS FOR THE RICH: How to Fund Your Roth With Over $100,000 Each Year," Will Duffy aggressively advocates this strategy.

Mr. Duffy argues that investing in Roth IRAs is far superior to investing in taxable IRAs. Throughout the book he compares a 40-year-old couple investing $55,000 each year, until age 65, in a Roth IRA (either directly or indirectly) versus the same couple investing $55,000 each year, until age 65, in a regular IRA. The purpose of this book review is to investigate three important areas which the book does not appear to address (at least sufficiently), but which are nevertheless crucial in conducting a regular IRA versus Roth IRA investment analysis.

**What happens with the funds not invested in the regular or Roth IRA?**

Using the main example in this book, this investor obviously has $110,000 of surplus taxable income lying around each year. This is because $55,000 will be invested in the Roth IRA and $55,000 will be paid to the IRS and state taxing authorities, based on the author's assumption that 50% federal income tax rates are on the near horizon. (A 50% combined federal and state income tax rate on income in excess of 400K a year won't be that unlikely by the year 2026, if not sooner under a Biden presidency, at least on designated types of income.)

The author illustrates that, at age 90, the couple's Roth IRA will be worth approximately $29.7 million (apparently because the couple will never withdraw any of the funds for living purposes), while the regular IRA owner would net about $19.2 million (apparently assuming RMDs beginning at age 70-1/2), after factoring in income taxes on the required minimum distributions and on the reinvested after-tax RMDs, apparently at a 50% tax rate for all income, for a $10.5 million net advantage in favor of investing in Roth IRAs over regular IRAs.

If we assume the couple's other assets (i.e., home and/or other savings) are worth $2 million, at age 90 the couple would have $31.7 million in the Roth example and $21.2 million in the regular IRA example—again, based upon the apparent assumption that the owner uses none of the regular or Roth IRA funds to live on. If we further assume today's approximately $11.5 federal estate tax exemption, today's 40% federal estate tax rate and no state estate tax, the couple's family would owe a minimum of $3.5 million in federal estate taxes in the Roth example, and $0 in federal estate taxes in the regular IRA example. [Of course, estate tax exemptions are likely to decrease in the future (on a relative basis), so even if the couple spends half the regular or Roth IRA funds during their lifetime, and estate tax exemptions are eventually cut in half, there would still be significant federal estate taxes to pay in the author's Roth IRA example, though likely none in the regular IRA example.]

Assuming the 50% income tax rate which the author feels is coming by the year 2026 (if not earlier, after the election), in the regular IRA example the clients would have another $27,500 to invest each year, outside of their regular IRA, as the tax savings generated by the $55,000 tax deduction. In contrast, the Roth IRA investor would have given the entire remaining $55,000 to the IRS each year, in taxes, and would therefore be left with nothing else to invest, outside of their Roth IRA. What happens to this annual $27,500 income tax savings? According to the author, this savings "doesn't exist anymore," apparently because no one ever keeps track of it. But just for fun, I decided to keep track of it.

Compounded monthly at the author's assumed rate of 8%, for 25 years (i.e., until the couple's retirement age 65), the $27,500 annual tax savings would grow to $2,179,439. Compounded monthly at 8% for an additional 25 years, or until age 90, this $2,179,439 would grow to approximately $15 million! Thus, rather than there being a $10.5 million advantage in favor of the Roth IRA approach over the regular IRA approach (assuming all income is taxed at 50%), there is actually a $4.5 million advantage in favor of the regular IRA approach over the Roth IRA approach—at the couple's age 90—assuming no taxes on the annually invested tax savings.

Now assume that the couple pays federal tax of 10% each year on the reinvested after-tax RMDs (i.e., based on qualified dividends and harvested capital gains, and not on the portion of the after-tax RMDs reinvested in tax-free reinvestments, including cash value life insurance). This would mean that their 8% gross annual return would be reduced to 7.2%, and the value of the couple's non-IRA account at age 90 would be reduced to approximately $11 million—still an approximately $500,000 advantage of the regular IRA investment approach over the Roth IRA investment approach. Remember too that, under existing law at least, the couple's family would receive a stepped-up income tax basis on all of the couple's taxable investments outside of the regular IRA at death, thereby effectively eliminating income taxes on the remaining built-in capital gain at death.

What is more, although a full discussion of the topic is beyond the scope of this book review, if estate taxes are a concern for the couple, all or a portion of the $27,500 annual advantage of the regular IRA approach over the Roth approach, plus the after-tax RMDs the couple begins receiving at age 72, could be invested (in taxable and/or non-taxable investments) inside of a so-called "spousal access trust," which would provide spousal access to the trust's income and principal without the estate tax concerns. This significant additional estate tax advantage associated with the regular IRA investment plan would not be available under the Roth IRA investment plan, at least as the plan is promoted by the author.

If the couple only has $76,500 in surplus pre-tax funds to invest each year, and is not able (easily, at least) to invest the full $55,000 in a regular 401K plan (including a solo 401K plan), they might instead choose to invest $12,000 each year in a regular IRA and invest the balance (i.e., after 50% income taxes) or $32,250, in other investments which do not throw off significant current income, including income tax-free cash value life insurance.

**Is a 50% tax on all income at retirement a realistic tax rate?**

The author assumes RMDs will be withdrawn and reinvested by the IRA account holder at the maximum federal income tax rate each year. Especially given (i) the demise of the corporate pension plan, (ii) the fact that federal tax brackets are annually adjusted for changes in the "chained CPI" rate, and (iii) the fact that most of the couple's income will probably not be subject to tax until actually distributed (as RMDs or otherwise) from the taxable IRA or until capital gains are actually recognized in the couple's taxable account, a more realistic assumption should be that the retired investor will be taxed at a much lower rate than 50%. If this hypothesis is correct, and utilizing the author's example, the above-described minimum $500,000 advantage which the regular IRA investment approach already has over the Roth IRA investment approach would actually turn out to be a much greater advantage.

Assume, for example, the couple is fortunate enough to be able to transfer $55,000 a year to a regular IRA for 25 years, starting at age 40, and begins taking RMD withdrawals at the new maximum age 72, when the account owner's taxable IRA account would have grown to almost $8 million (assuming the same 8% rate of return the author assumes). The RMD factor at age 72 is 27.3 (using the revised 2021 life expectancy tables), and RMD for the year would be $293,000.

Remember, however, that $293,000 is the taxable RMD amount 32 years from now, and that tax brackets are adjusted for inflation. Assuming a 2% annual change in the “chained CPI” rate, $293,000, 32 years from now, is the equivalent of $155,475 today. Using 2020's tax tables, and assuming the standard deduction amount for a couple both over age 65 with no other sources of income, the federal tax on this amount is $19,757, which works out to an effective average tax rate of only 12.92%, not the 50% rate the author assumes in his comparative analysis. The author has thus overstated the couple’s age 72 federal income tax rate on the RMD by as much as 387%.

Of course, future tax rates will likely be higher than the 2020 rates (and probably sooner rather than later), and RMDs will become larger as the couple grows older. President-elect Joe Biden has not proposed increasing income tax rates on individuals making less than $400,000 (in today’s dollars) a year, however. Furthermore, even assuming the couple is age 85, the RMD under the revised tables would still only be the equivalent of 6.25%, and would likely even be lower than this, as life expectancy continues to increase over the next 45 years.

Assuming life expectancies do not increase over the 45-year period, and the value of the taxable IRA account (after all previous RMD withdrawals) remains at $8 million at the couple's age 85, the couple’s RMD at age 85 would be $500,000. On a present value basis, assuming a 2% average chained CPI growth rate over the 45-year period, today this number would be $205,098. Again utilizing 2020 tax tables for a couple over age 65 (i.e., because the couple would be making less than $400,000 a year, in today’s dollars), the federal tax liability on this amount would be $30,807 in today's dollars, for an average tax rate of 15.21%. The author has therefore overstated the couple’s age 85 federal income tax rate on the RMD by as much as 329%.

Now let's go back and add in the forgotten portion of the author's analysis described in the first section of this book review, i.e., the additional $27,500 in funds the couple will have available to invest each year under the regular IRA investment plan, beginning at age 40 and continuing through age 65 (i.e., on account of their not having to pay the Internal Revenue Service the full $55,000 in income taxes each year on a $55,000 Roth investment, assuming the same 50% marginal income tax rate the author assumes). As these funds are reinvested, we know the growth each year will not be taxed at a 50% rate. More likely, the effective tax rate on this reinvested account each year will be closer to the 10% rate assumed above, because the couple will only be taxed on the qualified dividends and harvested capital gains, and not on the tax-free investments, including cash value life insurance.

Of course, RMDs will continue to grow after the couple attains age 85 (although they are still only at 8.26% at the couple’s age 90, or only slightly above the author’s assumed 8% rate of return). But what nevertheless appears to be clear from the above analysis is that, especially in a world when the corporate pension plan is rapidly becoming a thing of the past—making scarce this previous source of outside income—and life expectancies are continuing to increase, making an assumption that all of the retired couple’s RMDs and growth in their outside account will be currently taxed at a 50% tax rate is probably going to be incorrect, most of the time. The initial hypothesis of this section should therefore be correct, and the $500,000 advantage which the regular IRA investment approach maintains over the Roth IRA investment approach, which was based on the author’s example and assumed 50% tax rate on all of the couple’s RMDs and growth in their outside accounts, should actually be a much greater advantage.

Most of the couple's potential taxable income, no matter how high, will either be inside of their regular IRA, and therefore not taxable to the couple until actually withdrawn by them (including via RMDs), or will be unrecognized capital gains inside of the couple’s taxable account and therefore not taxable to the couple until the investments are sold— or potentially never, to the extent the assets are held by the couple until death when they will receive a stepped-up income tax basis.

**Are there any additional tax advantages to investing in regular IRAs over Roth IRAs, which the book does not reference?**

The author makes a valid point that taxable RMDs could effect the amount of the retired couple’s Medicare premiums and/or taxable Social Security, assuming the couple’s other income has not already done so. However, the author fails to point out the

potentially more significant effect that failing to take available tax deductions for regular IRA contributions can have on the couple's current tax situation.

For example, to a large extent the new maximum 20% qualified business income deduction is dependent upon the taxpayer's taxable income, ignoring the deduction. The greater the taxpayer's taxable income, the greater the chance that all or a portion of the qualified business income deduction will be lost. Annually investing significant amounts in nondeductible Roth IRAs or 401Ks, versus the deductible IRA and 401K versions, can end up causing the waste of a significant taxpayer deduction.

Lowering the taxpayer's taxable income, or "adjusted gross income," can also help minimize or eliminate the 5% surtax on capital gains and qualified dividends, increase the potential of avoiding the 3.8% net investment income tax, increase the taxpayer's itemized deductions such as the medical expense deduction, and enable the taxpayer to qualify for certain tax credits such as the child tax credit. Similar to the 20% qualified business income deduction, the value of these latter tax benefits, which are pegged to the taxpayer's taxable income or "adjusted gross income" can be significant, and therefore electing to forego a deductible regular IRA or 401K contribution in favor of a nondeductible Roth IRA or 401K contribution can be very damaging in certain cases.

Finally, not to be overlooked is the potential impact of parents' taxable income on qualifying their children for college financial aid, which of course has become a significant issue for many families, including families which may be "well off" financially, but who have multiple children. A financial advisor must be sensitive to this potential non-tax situation and to the various tax issues outlined above.

**Summary**

While there is no doubt the Roth IRA definitely has its place in financial planning, including when it comes to converting taxable IRAs to Roth IRAs, over time, after retirement, this book review has hopefully at least opened the reader's eyes to the realization that investing in non-tax-deductible Roth IRAs will not always be preferable to investing in regular, tax-deductible IRAs. There are a host of factors to analyze before making this decision, most of which will be based on the facts and circumstances of the particular client.

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