



**The Partial Roth Conversion is a
Most Valuable Tax-Planning Strategy**

Introduction

The Roth IRA is one of the most important and available of all retirement and tax planning strategies. It is worth all this attention because it can substantially reduce the total income taxes paid by individuals, their families, and their beneficiaries. Now is a very good time to think about how we might use a Roth IRA or a Roth conversion to our advantage, for both 2022 and for future tax years.

The Roth IRA is the **alter ego** of most qualified retirement savings plans. The Roth IRA is **after-tax** money that **grows income tax free** and is **income tax free when ultimately distributed**. Traditional IRAs and qualified retirement savings are made with **before-tax money**, money that grows tax-deferred and where income taxes are paid later when and as funds are ultimately distributed.

Pay Uncle Sam Now or Pay Uncle Sam Later

When do you want to pay taxes on your retirement savings, **NOW or LATER**? You are probably thinking NEVER, right? Aren't we all? A tax-free life is not of this earth so we have work to reduce our income taxes instead.

If your taxes are lower this year, you might want to pay taxes now. You could use a Roth IRA (or Roth 401k) for this year's retirement savings. If you think your taxes are probably higher this year, you **might prefer** to pay taxes later. You could make your savings contributions now before-tax instead, to your traditional IRA or 401(k).

"If you're in that window where you're retired, and there's going to be some years before Social Security and RMDs kick in, you should be looking at this at least." Barron's, April 10, 2022'

Multiple Conversion Motivations

Roth IRAs have several other significant features also. Consider these advantages.

There are no RMDs--no Required Minimum Distributions--with a Roth IRA. Avoiding RMDs is very valuable benefit for some people and so they do Roth conversions in substantial amounts. RMD requirements can become very substantial after age 80. Even with the latest RMD table (2022), all RMDs after age 90 are over 8% -- and always increasing annually.

Some people want the tax diversification that having Substantial Roth IRA money would allow. Because higher taxable income brings much higher taxes of course, but can also trigger higher taxes on Social Security and higher Medicare premiums. This strategy works to manage and reduce one's taxable income while maintaining one's retirement income.

That is because having a substantial Roth IRA asset means a tax-free source of income is available for current retirement income needs without those Roth distributions causing higher taxable income. One uses Roth distributions to manage their taxable income and any tax-related side effects. That can be done if one has a larger tax-free Roth bucket to dip into when needed.





A Beneficiary's Inherited Roth Conversion

Many retiring and retired taxpayers are converting some of their IRA money to Roth IRAs for the purpose of leaving an income-tax free inheritance to children and grandchildren. If Roth Conversions are done during retirement, income taxes might be paid at lower tax rates. Leaving a traditional IRA to beneficiaries who may be fully employed and have career jobs could cause the taxable IRA to be stacked on top of already substantial amounts of income.

Even with the option to distribute inherited IRAs over 10 years, any substantial IRA distributions on top of substantial other income causes a high probability that beneficiaries will be taxed at maximum income rate rates. Leaving substantial amounts of Roth money to beneficiaries instead of IRA money can make a substantial after-tax difference. There might be a reduced estate tax or inheritance tax also, where those may apply.

Roth IRA funds left to non-spouses and most other beneficiaries are subject to the 10-year Rule. That 10-Year Rule requires 100% distribution from the Roth (and any IRA or qualified retirement account) by the end of the 10th year following the year of death. Those Roth distributions that are ultimately 100% are not income taxable.

The 10-Year Rule is how the Federal government will prevent most non-spouse beneficiaries from deferring inherited money inside Roth and other qualified accounts for decades-long periods of time. Uncle Sam apparently wants to be paid taxes at higher rates and at sooner times than he did before 2020 when the SECURE Act changed this tax provision.

Nonetheless, despite the 10-Year Rule, some IRA owners leave their Roth IRAs in a conduit trust in order to control and mandate a very long distribution and protect the trust principal over the longer term. The income tax advantages would be gone after 10 years but the trust could bring protection advantages to prevent spendthrift behavior, fraud, divorce dissipation, and funds mismanagement.

Too Old to Convert? ...Think Again

There is no age when a person is too old to do a Roth conversion. Older individuals may think they do not have a long time to reap the benefits of a conversion, but that overlooks the potential of using a Roth conversion as an estate planning strategy. **“Roth Conversion for All Ages” Ed Slott’s IRA Advisor**²

Winning With the “Fill-the-Bracket” Strategy

The most common reason to do Roth conversions is the long-term potential to save significantly on income taxes. The most common strategy used to do this is the Partial Roth Conversion, something often called the **“Fill-the-Bracket”** strategy.

This is achieved by converting a part of your IRA and repeating the action over some number of years. Because tax rates increase for higher amounts of income, you convert only a portion of your IRA at a time so you will be taxed in lower brackets and at lower rates.



2023 Income Tax Rates and Brackets		
Taxable Rates	TOP of Single Filing Tax Brackets	TOP of Married Filing Joint Tax Brackets
10%	\$11,000	\$22,000
12%	\$44,725	\$89,450
22%	\$95,375	\$190,750
24%	\$182,100	\$364,200
32%	\$231,250	\$462,500
35%	\$578,125	\$693,750
37%	unlimited	unlimited
Numbers above are the last dollar taxed at the rate shown. All dollars above each bracket's top amount are taxed at the rate of the next bracket. Source: Internal Revenue Service, 2023		

A couple that is Married Filing Jointly could earn up \$89,450 plus the \$30,700 standard deduction (if both 65+) for a total of \$120,150 before being taxed above 12%. If this couple had \$50,000 of taxable income, they could convert \$70,150 of IRA to Roth and pay only 12% income tax for the conversion.

A 12% conversion tax rate is an incredible tax bargain. You should not pass up this opportunity if it exists for you. A 22% conversion tax rate applies to the income above the 12% bracket. A couple could earn up to \$221,450 and could fill their 22% tax bracket with IRA-to-Roth conversion income. Their average tax rate would be approximately half of the 22% marginal and maximum rate.

A “Fill-the-Bracket” Example

Retired couple age 70 with \$250,000 IRA . Has \$40,000 Joint Income (AGI all taxable sources) and \$30,000 combined Social Security Income	
Add Top of 12% bracket \$83,550	\$89,450
Add \$28,700 standard deduction plus two Over-65 “extras”	\$ 120,150
Subtract \$40,000 Earned Income	\$ 80,150
Subtract \$30,000 Social Security income	\$ 50,150
Amount for Roth Conversion	\$ 50,150
Marginal income tax rate on converted amount	12%
Federal income tax cost	\$9,754 (8.12% average)
This is a hypothetical example provided for illustrative purposes only.	

Reviewing Your Most Recent 1040 Tax Return

This fall and not later than Thanksgiving probably, you could estimate your taxable income and Social Security for the year. If not much has changed since last year, look at your Form 1040 and subtract your taxable income plus Social Security from the top of your bracket, \$120,150 or \$221,450 and convert up to that amount. Use either the 12% or 22% bracket, as you decide (or evaluate for both brackets). You subtract that number from the total of the Top of the Tax Bracket amount plus your Standard Deduction.

That is the “Filling the Bracket” strategy, a method of minimizing income taxes over one or two generations and creating a substantial fund for tax-free growth and distributions. You can convert up to that amount of the difference and pay what should be a relatively reasonable tax rate. As a result, you and yours never seemingly have to pay taxes on this money again.

Paying Taxes on the Roth Conversion

The usual and better method of paying the income taxes on the conversion is to use other non-qualified money to pay the taxes. Some people decide how much income tax they will pay this year, using non-qualified funds. Rather than a “Fill the Bracket” strategy, a person decides, for example, that they can afford to pay \$20,000 in taxes out of pocket. Since they are in a 25% combined federal and state bracket, in our example, they divide \$20,000 by 0.25 which equals \$80,000 so they do an \$80,000 conversion.

We think the Roth conversion opportunity is very valuable and we would rather not reduce the ultimate benefit. We don’t want to reduce the amount of future potential conversions by using IRA funds to pay the income taxes on today’s conversion. That’s not the most efficient way of making Roth conversions. Some experts see this as “paying taxes on money used to pay taxes.”

IF Roth conversion is a compelling enough idea, you can justify paying income taxes from the IRA funds. IF you are using IRA funds to pay the taxes and you are using the Fill-the-Bracket strategy, you are working to minimize the taxes paid on your converted amounts. At least the taxes paid with qualified funds were taxed at a minimized rate. So, you would do your IRA-to-Roth conversion as described above and only rollover 85% or 75% of the IRA amount distributed to pay taxes, depending for example on whether you were filling to the top of the 22% bracket or just the 12% bracket.

You should confirm the potentially substantial income tax consequences of your Roth Conversion with your own income tax professional.



Almost Anyone Can Do a Roth Conversion

I want to continue this discussion by opening one more door. You can do Roth conversions if you have an IRA. You can do a Roth conversion at any age. You can even still be working full time or part time and do a Roth conversion.

Suppose you do not have an IRA, suppose all your retirement savings are in your 401(k) plan where you work (or used to work), can you still do a Roth Conversion? Yes, you probably can.

You can do an IRA rollover of any 401k account still with a former employer. Once you have done that, you are free to act on your Roth conversion plans. IF your 401k account is with your current employer and you are age 59 ½, there is still a good probability you can do a Roth conversion. There are just a few more steps to take.

Your current 401k plan probably allows what is called an In-Service Withdrawal. This is the non-taxable withdrawal and transfer to an IRA you own or create. You don't move all your 401k but 50% or 75% of it instead. Continue with your current 401k contributions also and continue your retirement savings.

You can do another In-Service Withdrawal a few years down the road if you want or you can wait until you retire to an IRA rollover. Once you have the IRA account funded, it's a simple matter to begin doing partial Roth conversions after that.

Multiple Partial Conversions with ONLY One Annuity

Several insurance companies allow the partial conversion of a client's IRA indexed annuity to a Roth indexed annuity INSIDE the existing annuity. The IRA annuity advantages are several. Indexed interest should be more interest. IRA principal and prior interest is guaranteed against loss by the annuity company. Many people use annuities for IRA money for these reasons alone.

What is brilliant is that the annuity company creates a mirror image of the IRA annuity for that part of the annuity money that is Roth. This is one annuity but with separate two pockets, and IRA and a Roth. There is no new annuity to purchase; only a single form to complete and sign whenever you want to do a partial conversion. You receive a Form 1099-R taxable income notice and include that on the tax return. This "Two-Pocket" annuity is particularly valuable if the first IRA annuity purchased includes a guaranteed lifetime income rider or an enhanced death benefit rider.

The guaranteed lifetime income payments can cover one or two lives, which is a very valuable option. The portion of each income payment that is attributed to the Roth money is tax free. Any payments received after the IRA annuity has become 100% Roth annuity are income tax free. Those guaranteed income payments are tax free even if you live to age 100 and beyond. Those payments are tax free for the longer of two lives if you have a joint income payout.

If your IRA annuity has an enhanced death benefit (as a number of annuities do), that higher benefit paid to beneficiaries can continue to grow for even 10 more years without income tax. When the required 10-Year Rule distributions are eventually made in time, those too are all income tax free and so is their growth after death and before distribution.



Partial Roth Conversion Strategy Starts with the First Conversion

Committing to program of Partial Roth Conversions is similar in nature to making any long-term retirement planning or financial decision. You can imagine the benefits you expect to receive, and you have some idea of what the conditions are and what the requirements will be. You have an ultimate goal generally in mind. You can't see the future but you know that having more spending options and more tax-planning flexibility will allow you to make better financial decisions. You believe that a substantial Roth IRA asset can help you do that over the years of your retirement.

Bring your most recent form 1040 and your IRA and-or 401(k) statements to a retirement planning professional with expertise and experience in doing Roth Conversions. There is no obligation to exploring a better strategy for addressing income taxes during your retirement. A Partial Roth Conversion strategy begins when you choose this path and it continues only if and when as you choose to continue. You can review the Partial Conversion option each year based on your income tax considerations and your financial needs.

Footnotes

¹ “Keep a Lid on Social Security Taxes and Medicare Costs. Consider Roth IRA Conversions” Neal Templin, Barron's, April 10, 2022

² “Roth Conversion for All Ages” Ed Slott's IRA Advisor, August 2022.

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A fixed indexed annuity is intended for retirement or other long-term needs. It is intended for a person who has sufficient cash or other liquid assets for living expenses and other unexpected emergencies, such as medical expenses. A fixed indexed annuity is not a registered security or stock market investment and does not directly participate in any stock or equity investments, or index. All annuity contract and rider guarantees including those for optional benefits, crediting rates, or payout rates are subject to the claims-paying ability of the issuing insurance company. There is no additional tax-deferral benefit for an annuity contract purchased in an IRA or other tax-qualified plan.

Please note, changes in tax laws or regulations may occur at any time and could substantially impact your situation. While familiar with the tax provisions of the issues presented herein, M&O agents are not qualified to render advice on tax or legal matters. Unless certain criteria are met, Roth IRA owners must be 59 ½ or older and have held the IRA for five years before tax-free withdrawals are permitted. Additionally, each converted amount may be subject to its own five-year holding period. Converting a traditional IRA into a Roth IRA has tax implications. Investors should consult a tax advisor before deciding to do a conversion.

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