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Creating Wealth Using Tax Bracket Optimization

Prior to 2010, converting all or part of your IRA to a Roth IRA was only an option for those with adjusted gross income of $100,000 or less. Now, the IRS allows everyone to convert their IRA to a Roth IRA. Unfortunately, most people shy away from a Roth conversion due to the upfront tax that must be paid on the IRA funds that are converted.

In the past, deferring the recognition of income for as long as possible has been an effective strategy. Today, with a greater number of tax brackets, higher rates, itemized deduction and personal exemption phase-outs, as well as a sur-tax, the deferral strategy can be a lesser attractive option if future income recognition will push individuals into a higher tax bracket.

Most Roth conversion strategies involve tax bracket arbitrage; reporting income when your tax rate is lower. For example, if you file your income tax return as Married Filing Jointly and are in the 25% marginal tax bracket, you might be better off converting a portion of your IRA to a Roth each year to completely fill up the 25% bracket. Taking more income and paying taxes in the present allows you to take less income in the future when Required Minimum Distributions ("RMD's") might propel you into the next higher tax bracket. The optimal result can be a "flattening" of your cumulative tax rate over your lifetime and a significant increase in your portfolio value due to tax savings. In addition, Roth IRA's grow tax-free and do not require any RMDs at age 70 ½, which can allow for greater long-term net worth accumulation.

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Who Should Convert?

You will want to consider this strategy if you meet the following criteria:

• **You are currently retired or are otherwise in a low income tax bracket.** When you convert to a Roth IRA, the amount that you are converting will be taxed 100% at ordinary income rates. Therefore, it is best for you to initiate a Roth conversion in years that you are in a low income tax bracket.

• **You are not yet 70½.** Once you turn 70½, your retirement accounts (traditional IRAs, 401(k)s, etc.) are subject to RMDs. This means that you are forced to take a specific amount out of your retirement accounts each year. This often forces retirees into a much higher tax bracket and unfortunately, the RMD cannot be converted to a Roth IRA.

• **You have funds outside of your retirement accounts to pay for the additional taxes.** If you don't have excess cash outside of your retirement accounts to pay the tax due on the Roth conversion, you are not a good candidate for this strategy.

How to Convert

If you decide you could benefit from a full or partial Roth conversion in any given year, consider following this strategy:

• **Convert only partially to maximize income in your current tax bracket.** A wealth advisor can work with you to figure out the maximum amount you can convert without pushing you into the next marginal tax bracket. As income can vary from year to year, you should do this calculation on an annual basis.

• **Pay any tax owed from your taxable accounts.** It is important that you don't withdraw funds from your converted IRA to pay taxes on the conversion, as you will lose most of the benefit of the conversion. Make sure you have enough money to pay the estimated tax on the conversion outside of your IRA account.

Paying taxes now might actually help save on taxes in the future, as well as allow for additional wealth creation. At Rinehart, we realize that each client's situation is unique, and we can assist with deciding if a Roth IRA conversion is the best option for your situation.

Sandy Carlson has over eighteen years of wealth management experience including income taxation, retirement planning, executive compensation planning, insurance, banking, trust administration and estate planning. She is a Certified Divorce Financial Analyst™ (CDFA) and also holds the QKA designation by the American Society of Pension Professionals & Actuaries. She is President-Elect of the Financial Planning Association, a Tax Instructor in the CFP Program at Queens University, and is a member of the Charlotte Estate Planning Council. Sandy values getting to know her clients and providing creative, integrated solutions for accumulating, preserving and transferring wealth.