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Financial Planning Perspectives

Roths beyond retirement: Maximizing wealth transfers

Many investors hold substantial tax-deferred retirement accounts such as traditional IRAs and 401(k)s. Depending on their goals, they may want to think about converting some or all of those assets to a Roth IRA. Discussions about conversions most commonly focus on retirement planning and expectations for current and future tax rates. However, Roth IRAs can also serve as a wealth transfer vehicle in an estate plan, helping individuals to achieve—or amplify—their wealth transfer goals.

Consider the potential to transfer greater after-tax wealth.

When investors convert a traditional IRA to a Roth IRA, they are "prepaying" the income taxes for beneficiaries. Additionally, if an estate is large enough to be subject to estate taxes, the conversion removes the "double taxation" of these assets. Unlike those from tax-deferred accounts, distributions from a Roth account are not subject to income tax.

Evaluate tax rates for investors *and* their beneficiaries.

The potential benefits depend not only on the difference between the investor's current and future marginal income tax rates but also on the beneficiary's future tax rates. Realistically, future tax rates are uncertain in many cases, especially when planning across generations. The tax diversification benefits of a partial Roth conversion can help hedge that uncertainty.

Capitalize on annual tax planning opportunities.

Once an investor decides that a conversion is beneficial, he or she should take advantage of annual tax planning opportunities to maximize the benefit. Strategies we discuss include pairing partial conversions with charitable giving, making full use of low marginal income tax rates, taking Social Security income taxation into account, and planning within the Alternative Minimum Tax (AMT) envelope.

Note: Throughout this paper, we discuss only the *federal* tax rules and regulations in effect as of the writing of this paper; these are subject to change at any time. State tax rules vary and can have a significant impact on an investor's financial plan. Individuals should consult with their tax advisor before engaging in any transaction that might have tax consequences.

Consider a Roth conversion's potential to increase the after-tax wealth transfer of an IRA

From a wealth transfer perspective, Roth IRAs have two main advantages over traditional IRAs. First, they do not require account owners to take required minimum distributions (RMDs) during their lifetime. The amounts that would normally be paid out in RMDs and subject to income tax can continue to grow in the Roth IRA tax-free. This will likely result in a greater account balance when the IRA is ultimately transferred to beneficiaries. Second, qualified Roth distributions[1] are tax-free: No income tax is due when withdrawals are taken. These features can mean substantially greater ending wealth for beneficiaries.

Converting to a Roth IRA rather than keeping a traditional IRA can lead to significantly greater wealth accumulation over time.

How investors pay the taxes due at conversion can also have a significant impact. Roth conversions may be either *tax-exclusive* or *tax-inclusive.* If investors pay the taxes due with assets outside of the IRA, the conversion is tax-exclusive. This is often the better strategy as it transfers the entire pre-tax IRA balance to the Roth account, essentially increasing its after-tax value. On the other hand, in a tax-inclusive conversion, the income tax is paid from the traditional IRA and the beginning value of the Roth is reduced accordingly.[2]

Hypothetical scenarios

Figure 1 illustrates these points with three scenarios involving a hypothetical 65-year-old investor with a taxable account balance of $28,000, a traditional IRA balance of $100,000, and a 40-year-old non-spouse beneficiary. The account owner and beneficiary are both in the 28% tax bracket, and the beneficiary inherits the IRA and the taxable account after 20 years. Figure 1 shows the combined after-tax liquidation value of the IRA and the taxable account over time for all of the scenarios below. For simplicity, we assume no estate taxes are due at the account owner's death and the income tax rate for both parties remains constant over time.

Scenario 1: The account owner maintains the $100,000 traditional IRA and the $28,000 taxable account, reinvesting all income and dividends. She begins taking RMDs at age 70½ and reinvests the after-tax proceeds in her taxable account. Upon inheriting the IRA, her beneficiary begins taking RMDs according to his life expectancy and reinvests them, net of taxes, into the taxable account.

Scenario 2: The account owner converts the entire traditional IRA to a Roth IRA and pays the conversion taxes from the IRA while maintaining the taxable account (a tax-inclusive Roth conversion), leaving her with a $72,000 Roth IRA and a $28,000 taxable account. She does not take any withdrawals from the Roth IRA during her lifetime. Upon inheriting the Roth IRA, her beneficiary takes RMDs (income-tax free) based on his life expectancy and invests them in the taxable account.

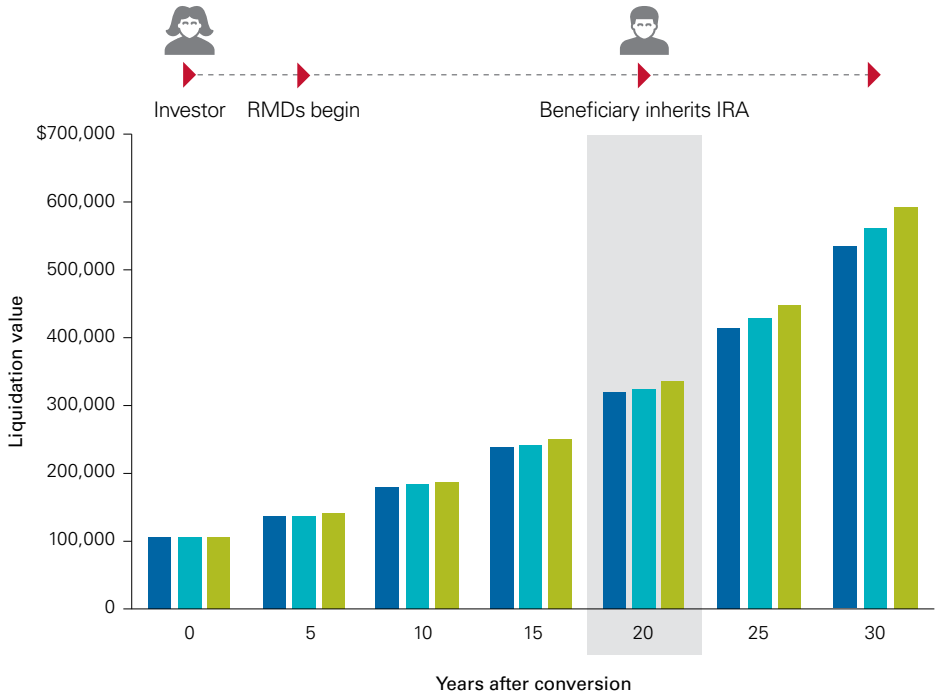
Scenario 3: Identical to Scenario 2, except the account owner pays the conversion taxes using the money in her taxable account (a tax-exclusive Roth conversion with the full balance converted), leaving her with $100,000 in her Roth IRA and no balance in her taxable account.

1 In order to be considered "qualified," distributions must occur at least five years after the first contribution to a Roth IRA for the owner's benefit. For converted IRAs, a separate 5-year holding period applies for each, starting on the first day of the calendar year for each conversion. Additionally, the owner must be at least age 59½ or disabled at the time of the distribution, or the distribution must be made to a beneficiary or the owner's estate after the owner's death. Other exceptions exist. See *IRS Publication 590-B* for details.

2 Note that if an investor makes a tax-inclusive conversion prior to age 59½, the taxes paid from the IRA will be considered a premature withdrawal subject to income tax and an additional 10% penalty.

As Figure 1 shows, converting to a Roth rather than keeping a traditional IRA can lead to greater after-tax wealth being passed to the investor's beneficiary. This is especially true if the taxes on the conversion are paid with funds outside the IRA. Converting to a Roth initially reduces total wealth by the amount of the income taxes paid. However, because RMDs are not required during the account owner's lifetime, the balance of the Roth IRA may be drawn down more slowly than that of a traditional IRA. This means more of the Roth IRA can benefit from tax-free compounding for longer, possibly resulting in significantly more wealth over time.

Figure 1: A tax-exclusive Roth conversion may result in more wealth



Traditional IRA	$323,085	$540,327
Tax-inclusive Roth IRA	$328,823	$567,523
Tax-exclusive Roth IRA	$339,956	$598,579

Notes: Amounts shown are the combined after-tax liquidation value of the IRA and taxable accounts at the end of each year. Liquidation values reflect the investor's tax rates through year 15 when the beneficiary inherits the accounts, and the beneficiary's tax rates and stepped-up basis in Years 20 and beyond. The data assume a 6% annual rate of return on a 50% stock/50% bond portfolio, with all income and dividends reinvested. Portfolio returns consist of 3.3% from capital gains and 2.7% from income, including 1% from dividends, which is consistent with the historical average breakdown of returns on a 50/50 portfolio. Assumed rates of return are hypothetical and are not guaranteed. Distributions from the traditional IRA and income received in the taxable portfolio are taxed at a rate of 28%. Dividends and capital gains in the taxable portfolio are taxed at a rate of 15%. The data also assume that the portfolio is rebalanced annually in the tax-advantaged account and/or using portfolio cash flows with no turnover in the taxable account. Liquidation values ignore the five-year holding period for Roth IRAs.

Source: Vanguard.

Other estate-planning advantages

In addition to potentially passing greater wealth to beneficiaries, a Roth conversion may also provide two important estate-planning advantages (see **Figure 2**):

- **Elimination of double taxation.** If an estate is large enough to incur estate taxes,[3] the beneficiaries must pay them on all assets beyond the exemption amount, including tax-deferred assets such as traditional IRAs, 401(k)s, annuities, and other retirement plans. They must also pay income tax on any withdrawals from these accounts, resulting in double taxation.[4] Thus, it is generally more advantageous to pass assets that do not have an embedded income tax liability, such as a Roth IRA or taxable assets.
- **Reduction of the estate through income tax on the conversion.** Upon conversion, the estate is reduced by the conversion taxes paid and any future appreciation of those dollars. Even if the reduction isn't large (and many individuals are not subject to estate tax at all), using this method does not reduce the owner's gift/estate tax exemption. However, because the investor's estate will include the Roth IRA (and its potential growth), a Roth conversion may increase a taxable estate over time, possibly beyond the savings achieved by converting. For those with sizable estates, it is especially important to consider all of the implications before making a decision.

For individuals subject to estate tax, a Roth conversion can eliminate double taxation of IRA assets.

Figure 2: Tax impact on investors and beneficiaries of traditional vs. Roth IRA

Type of IRA	Impact of converting on taxable estate	Beneficiaries' future income tax liability
Traditional	No impact	Distributions are fully taxable
Roth	Reduces estate by amount of taxes paid at conversion (and future appreciation of those dollars)	No impact

Source: Vanguard.

3 For 2016, the federal gift and estate tax exemption is $5,450,000 per individual. This is the total amount an individual can pass free from gift and estate taxes. Lifetime gifts that use a portion or all of this exemption are deducted from the estate tax exemption amount when calculating the taxable estate. Any assets held by the estate in excess of the remaining exemption are taxed at a maximum rate of 40%.

4 An income tax deduction based on the estate tax paid on the IRA is available for beneficiaries in this situation. However, it is unlikely that the deduction will entirely offset the required distributions from the IRA, and in practice, most beneficiaries fail to take advantage of it.

Evaluate current and future income tax rates for investors *and* their beneficiaries

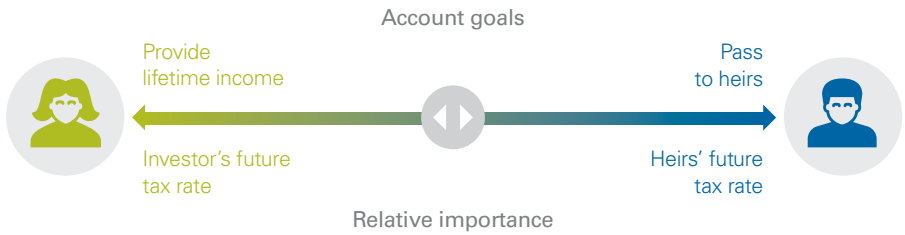
The potential benefits of a Roth conversion hinge greatly on tax expectations—the current marginal income tax rate versus the rate when withdrawals from the traditional tax-deferred retirement account will be made. A common rule of thumb is that if an investor anticipates similar or higher tax rates in the future, then a Roth conversion will likely be advantageous. If the marginal rate will most likely decline in the future, then maintaining the traditional tax-deferred account may be a sound choice.

The decision becomes more complex when planning across generations, but understanding investors' goals for their retirement accounts can help (see **Figure 3**).

- Individuals intending to make significant withdrawals from the account for retirement spending should weigh their current marginal income tax rate relative to their expected rate in retirement, factoring in variables such as RMDs and Social Security claiming decisions.
- On the other hand, investors intending to transfer the account to their beneficiaries should consider the beneficiaries' future marginal income tax rate. If the beneficiaries will likely be in a similar or higher bracket, converting may be the better option because the conversion taxes will be paid at the investor's tax rate, and the appreciation of the Roth assets will be sheltered from future income taxation.

When earmarking IRA assets for heirs, consider the outlook for their tax bracket.

Figure 3: Tax rate considerations depend on account goals



Source: Vanguard.

This "current versus future marginal income tax bracket" guideline should be viewed only as a starting point. Regardless of an individual's income tax outlook, with good financial planning, a Roth conversion could be useful because of other tax and estate planning considerations. As with any financial plan, it is also important to understand the investor's goals and time horizon. Weighing these factors holistically offers the best chance to meet financial goals while minimizing implementation costs such as taxes.

Tax diversification can hedge future tax uncertainties

Many individuals, of course, are uncertain about what their (or their beneficiaries') future tax picture will look like. Even so, it may still be valuable to increase tax diversification through a partial conversion.

A portfolio consisting of various account types—such as taxable, tax-deferred retirement, and Roth (tax-free) retirement accounts—provides the most flexibility in managing current and future income goals to maximize tax efficiency. For the many individuals entering retirement today whose accounts consist mainly of tax-deferred retirement assets, a partial Roth conversion is one way to build tax diversification. This can not only help manage the annual tax bite of withdrawals during retirement but can also be a valuable part of an overall wealth transfer plan.

Stick with a traditional IRA for charitable bequests

Investors intending to leave a portion of their estate to a charity may find it advantageous to make the charitable bequest from a traditional IRA and leave taxable assets to their non-charity heirs. Because charities are typically tax-exempt, they do not have to pay income tax on the IRA and will receive the full value of the assets at the time of the bequest. Furthermore, non-charity heirs can benefit from a step-up in basis on taxable assets. This will reduce, if not eliminate, any capital gains tax that otherwise would have been due.

Tax-savvy annual planning may ease the tax bite of Roth conversions.

Capitalize on annual tax planning opportunities

- **Offset conversion income tax when making charitable contributions.** Individuals who are charitably inclined can consider planning annual gifting around Roth conversions. Charitable contributions may typically be deducted up to 50% of adjusted gross income.[5] Because a Roth conversion increases adjusted gross income, investors can potentially make larger deductible charitable contributions in the year(s) they convert. This can further their charitable giving strategy and reduce the tax impact of their Roth conversions at the same time.
- **Maximize full use of low marginal tax brackets.** Some individuals may find that their income is lower in the earlier years of retirement, before RMDs and Social Security benefits start. This may be an optimal time to convert.[6] They can take full advantage of their lower marginal income tax rates during these years by doing a series of partial conversions to "fill up their tax bracket." Similarly, years in which investors have large tax deductions that place them in a lower tax bracket than normal can also offer excellent conversion opportunities.[7]
- **Consider converting if you are paying AMT.** Individuals subject to Alternative Minimum Tax (AMT) may be able to reduce the taxes they pay on a conversion. Their AMT rate[8] will likely be lower than the marginal income tax rate they would pay otherwise. Depending on circumstances, the conversion amount could be taxed at the lower AMT rate as opposed to the higher rate. Working closely with a tax planner can help investors strike the right balance between converting as much as possible and still remaining within the AMT envelope.

5 Certain contributions are limited to 30% of adjusted gross income. See *IRS Publication 526* for more detailed information. Also, married taxpayers filing jointly with income of $311,300 (and single filers with income of $259,400) and above are subject to Pease limitations on itemized deductions, including charitable contributions.

6 Vanguard's IRA Insights research has found that conversions rise between ages 60 and 70. We call this pattern the "Roth conversion zone."

7 Other industry experts advocate this strategy. For example, see Michael Kitces, https://www.kitces.com/blog/using-systematic-partial-roth-ira-conversions-and-recharacterizations-to-fill-the-lower-tax-bracket-buckets/.

8 For 2016, AMT income thresholds are $53,900 single/head of household or $83,800 married filing jointly.

- **Check into the effect of receiving taxable Social Security benefits.** Up to 85% of Social Security benefits may be taxable[9] depending on income. Because of the way this is calculated, taxpayers only slightly above the threshold can pay a significantly higher marginal tax rate. Individuals in this situation may choose to convert some traditional IRA assets. This will not lower their overall tax bill, but it may lower their marginal rate.
- **Look before you leap.** Capitalizing on tax planning opportunities can help amplify the benefits of a Roth conversion, but careful planning is needed. Converting too much in a given year can eliminate the benefit of these strategies and could even cause investors to pay more taxes than they otherwise would have. The additional income from a Roth conversion can have significant impacts on the taxability of Social Security benefits and Medicare Part B premiums, among other things.[10] Investors should consult with a financial planning professional to help ensure they benefit from tax planning opportunities without incurring any unpleasant surprises at tax time.

Conclusion

Financial planning and wealth management should be approached holistically, taking into consideration an individual's specific circumstances and goals. In the context of an estate plan, the trade-offs of a Roth conversion are heavily dependent on the individual situation and may not be easily quantifiable. Although the principles we have outlined can be a useful place to start, it is critical to consult with a qualified financial planning professional to ensure the full benefit of these strategies.

References

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9 There are two tax thresholds for Social Security benefits. For 2015, 50% of these benefits are taxable for married couples filing jointly with income between $32,000 and $44,000 ($25,000 and $32,000 for single filers). For married couples with income exceeding $44,000 ($32,000 for individuals), 85% of Social Security benefits are taxable.

10 A recharacterization (changing a previously converted Roth IRA back into a traditional IRA) may be possible if investors find they have converted too much. However, there are limitations on when recharacterizations may be done and what amounts must be recharacterized. Additionally, recharacterizations often involve filing amended income tax returns. We strongly recommend consulting with a financial planning professional to determine the optimal amount to convert before proceeding.

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