Defer No More?
Part II – The Year of the Roth

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Should you continue to defer taxes in a rising tax environment? Deferring income and taxes may not always be the best strategy. In fact, it may prove to be more costly and more tax inefficient over time for taxpayers in the highest brackets.

Many people hold too much of their wealth in tax-deferred accounts and there is a lack of tax efficiency when you do not know what your tax rate will be in retirement. Read on for strategies to reduce your tax-deferred account balances.

Reasons to have a Roth Bucket

- Qualified Roth distributions provide tax free income for you and your spouse for life with NO required minimum distributions (RMD).
- Qualified Roth distributions are tax free income to your heirs for 10 years after the last spouse to die.
- Establishes a tax diversified income stream which provides the ability to draw from different buckets according to tax treatment to manage your tax liability in retirement.
- Tax rates will be higher in the future.

Tax rates are rising

The Tax Cuts and Jobs Act of 2017, which lowered taxes, is set to expire at the end of 2025 absent further legislation. Rates will revert to pre-2017 levels and the top tax bracket is slated to return to 39.6%.

The national deficit and need for tax dollars is growing.

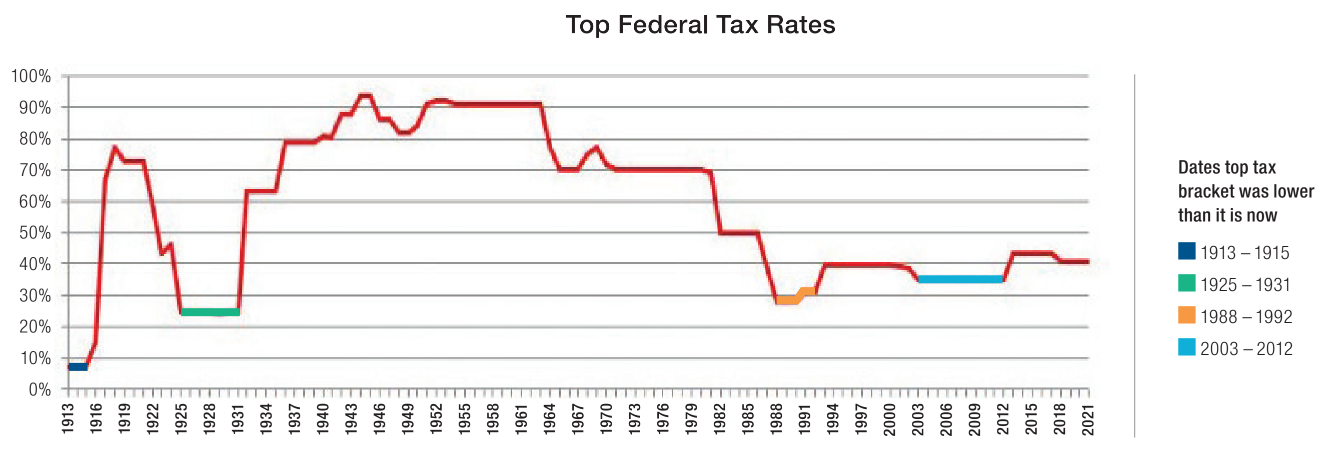
In addition to the expiration of the TCJA in 2025, the COVID-19 pandemic has squeezed government tax revenues while simultaneously requiring a sharp increase in government spending to combat the pandemic and its economic fallout. To make up for budgetary shortfalls, governments (state and federal) may need to raise their tax rates even more.

Over the past 100 years, the US Federal debt has increased from $408 billion in 1922 to $30.93 trillion in 2022
(source: fiscaldata.treasury.gov).

From FY 2019 to FY 2021, spending increased by about 50%, largely due to the COVID-19 Pandemic. Tax cuts, stimulus programs, increased government spending, and decreased tax revenue caused by widespread unemployment generally account for sharp rises in the national debt.

Historically low tax environment.

Top Federal tax rate has only been lower four other times in history.



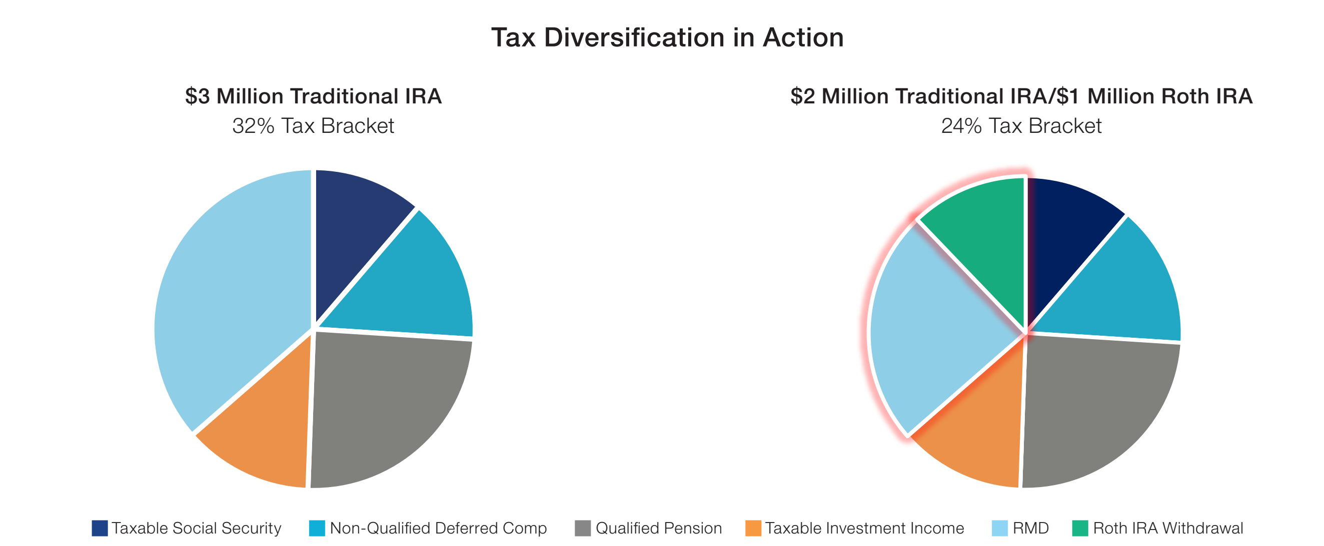
*Adjusted for inflation

Source: Historical Highest Marginal Income Tax Rates

Note: This table contains a number of simplifications and ignores a number of factors, such as the amount of income or types of income subject to the top rates, or the value of standard and itemized deductions.

Benefits of tax diversification

The example below shows the benefits of tax diversification in retirement. Over a period of several years the below client converted $1 million from their traditional IRA to their Roth IRA. The addition of the tax-free Roth bucket available in retirement allowed the client to manage taxable income by lowering their required minimum distributions (RMD) to stay within a lower 24% tax bracket. RMDs must begin by age 73 (will increase to age 75 in 2033) and are calculated by taking the 12/31 year-end balance of the qualified account and dividing it by a life expectancy factor according to your age.



Tax diversification is important to have when taking distributions, but it should not be the primary planning objective when converting to a Roth. The planning goal is to pay taxes on any given dollar when the applicable rate is the lowest.

The year of the Roth

Inflation adjusted 2023 tax brackets – convert more income at lower rates due to inflation

Due to high rates of inflation the 2023 tax brackets are greatly expanded. There is an unprecedented opportunity to convert more income at lower rates than in the past. A single individual in the highest tax bracket in 2023 will be able to convert $75,550 more than 2022 amounts. A married filing jointly couple in the highest tax bracket in 2023 will be able to convert $121,500 more than they were able to in 2022. Depending on the inflation environment, adjustments after 2023 may also be significant. In a progressive tax system such as ours, a taxpayer's marginal tax rate is higher than their average tax rate. Not all dollars are taxed equally.

Roth basics

Distributions

Qualified distributions are tax- and penalty-free. Roth IRAs must be held at least five years and at least until age 59½ to take tax-free and penalty-free withdrawals from earnings, but contributions can be withdrawn tax free at any time.

Contributions

The maximum that can be contributed to a Roth IRA in 2023 is $6,500 with a $1,000 catch-up contribution if over age 50. Contributions are limited depending on your Modified Adjusted Gross Income (MAGI). The ability to fully contribute to a Roth IRA is phased out for Single or Head of Household filers with MAGI over $138,000 and for Married Filing Jointly with MAGI over $218,000. If you earn too much money you cannot contribute to a Roth IRA.

Every plan participant, regardless of income can contribute to a Roth bucket if it is a feature available under their employer sponsored plan such as a Roth 401(k), 403(b) or 457(b). The maximum amount of salary that you can contribute to an employer sponsored Roth plan in 2023 is $22,500 + $7,500 catch-up contribution if you are over 50.

President Biden signed the 2023 Consolidated Appropriations Act (CAA) on December 29, 2022 (aka Secure Act 2.0) that introduced expanded ways to add Roth accounts to your retirement savings.

This includes the ability to create SIMPLE Roth accounts as well as SEP Roth IRAs. Also, employees will be able to elect to receive matching and/or nonelective contributions to their designated Roth accounts. These amounts will be included in income in the year of contribution and must be nonforfeitable (not subject to a vesting schedule). Although effective immediately, employers and plan administrators will need time to update systems, paperwork, and procedures to accommodate these changes.

Projected to be in the top tax bracket in retirement?

Convert as much pre-tax money to a Roth as you can afford and contribute the maximum Roth amount allowed by law before the end of 2025.

Beginning in 2025 there will be a mandatory "Rothification" of catch-up contributions for high-income taxpayers. Employer plan catch-up contributions for high-earners will be required to be made to Roth accounts. This rule would apply to those that have wages in the prior year from the employer sponsoring the plan in excess of $145,000.

Conversions

Roth conversions can be done by anyone without income restrictions. The amount subject to income tax is determined at the time of conversion. If you convert after your RMD beginning age, remember the first amount that comes out of a pre-tax account is always the RMD. Once the RMD has been distributed, you may convert additional pre-tax amounts to a Roth.

A Roth conversion may push your taxable income high enough to cause an income related monthly adjustment amount (IRMAA) in Medicare premiums if you are over age 65. Also keep in mind a Roth conversion may cause more of your Social Security income to be taxed. Please discuss with your KeyBank advisor and your tax professional the best tax strategy for your situation.

The opportunity to convert or contribute to a Roth should be decided on an annual basis depending on market conditions and prevailing tax rates.

Advanced Roth strategies

Back door Roth contribution

If you exceed the income limits, there is a way to add to a Roth IRA annually by making a nondeductible contribution to a traditional IRA and then immediately converting the amount to a Roth IRA.

Beware of the aggregation rule

Remember the aggregation rules when aggregating IRA balances to determine the portion of the conversion that is taxable. See part 1 of Article Defer No More? Why You Should Rethink Your Retirement Strategy | Key Private Bank for details. Once you comingle deductible and nondeductible contributions in a traditional IRA (includes SEP IRA and SIMPLE IRA balances), they remain mixed money and you must aggregate the balances to determine the ratio of deductible to non-deductible balances when taking a distribution or converting. This requirement applies even if the after-tax contribution was made to only one IRA. There is one potential work-around to this rule.

Isolate the after-tax or nondeductible balance in your traditional IRAs

If you have traditional IRAs (including SEP IRA and SIMPLE IRAs) that have non-deductible contributions, there is a tax advantaged way to isolate the non-deductible or after-tax dollars by rolling the pre-tax or deductible fund balance to an employer plan such as a 401(k). After-tax or non-deductible amounts, according to the IRS, are not eligible to be rolled to an employer plan so if you execute a rollover of the pre-tax or deductible fund portion, all that remains in the IRA is after-tax money or non-deductible funds.

Intra-plan Roth conversion

Many employer sponsored Roth 401(k) plans allow for an “intra-plan Roth conversion” or ability to convert prior pre-tax or after-tax (as long as tracked separately) employee contributions to the Roth bucket. A Roth conversion is taxed in the year of conversion and therefore adjustments to withholding or estimated tax payments may be recommended by your tax professional.

Convert previous rollover balances

If you rolled previous employer plan balances to your current employer plan, the IRS allows you access to this money. This money can be converted intra-plan to a Roth bucket or it can be re-rolled out to a traditional IRA or to a Roth IRA in a rollover conversion. Having a bucket of Roth money outside of an employer plan allows you to have more control on when Roth distributions can be taken and could provide expanded investment choices.

CASE STUDY

Fill up current tax bracket for three years

Planning challenge

Clients are projected to have more taxable income then their projected spending in retirement. RMDs are projected to be significant when they turn RMD age 73.

Facts

Currently 66-years-old, projected age at death 94 for husband and age 96 for wife, married filing jointly, both retired. Current Net Worth $3.95 million. Projected tax bracket in retirement 33%. Balanced investment objective projected average annual return 6.43%.

Solution

Take advantage of expanded tax brackets due to inflation, series of Roth conversions for three years. Roth conversion tax bracket 33%. (Year 1 $349,904, Year 2 $362,249, Year 3 $379,149). Even though the tax bracket is the same at conversion and at retirement it provides years of tax-free growth as soon as taxes are paid on the conversion.

Result

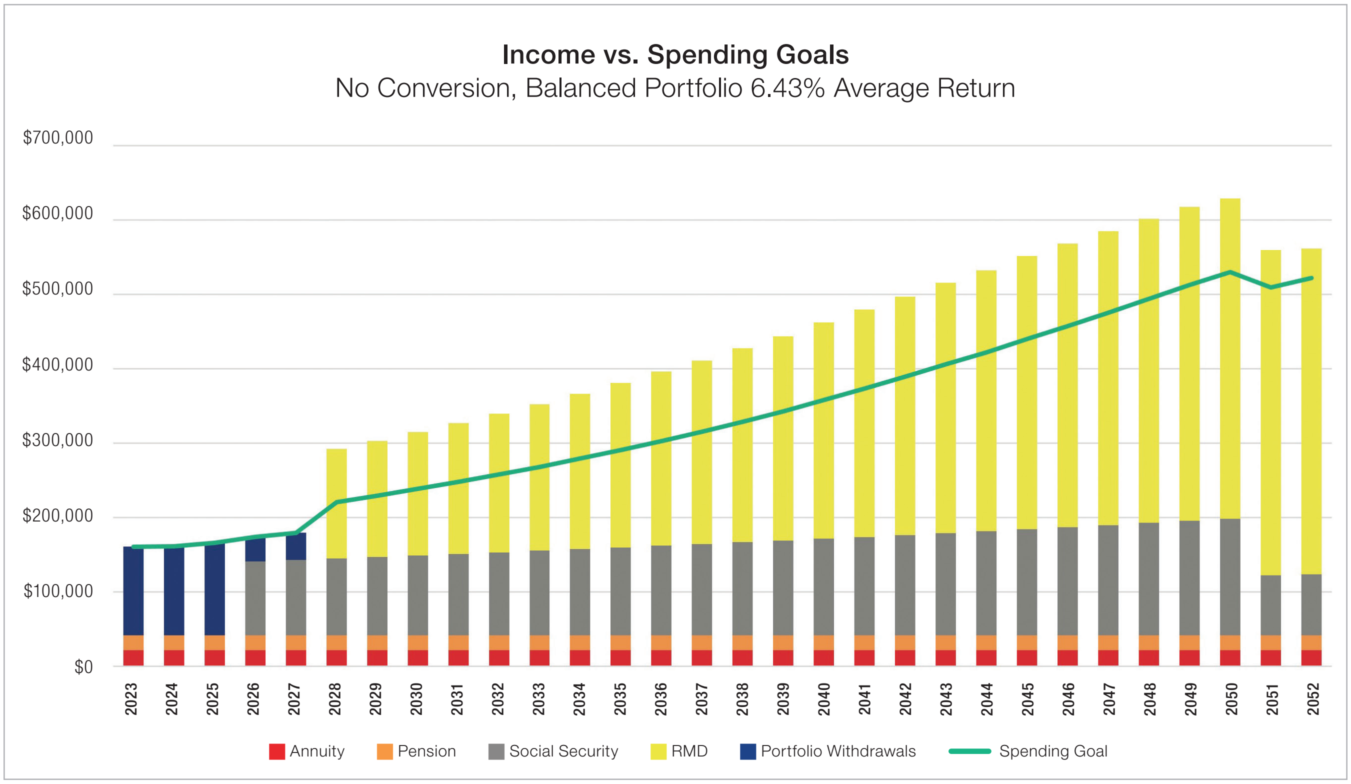
Total Estimated Lifetime Tax Saving $515,890*. The benefit of having an additional 10 years of tax-free growth for beneficiaries is not included in this analysis but would result in additional savings.

First year RMDs have been reduced by 31%

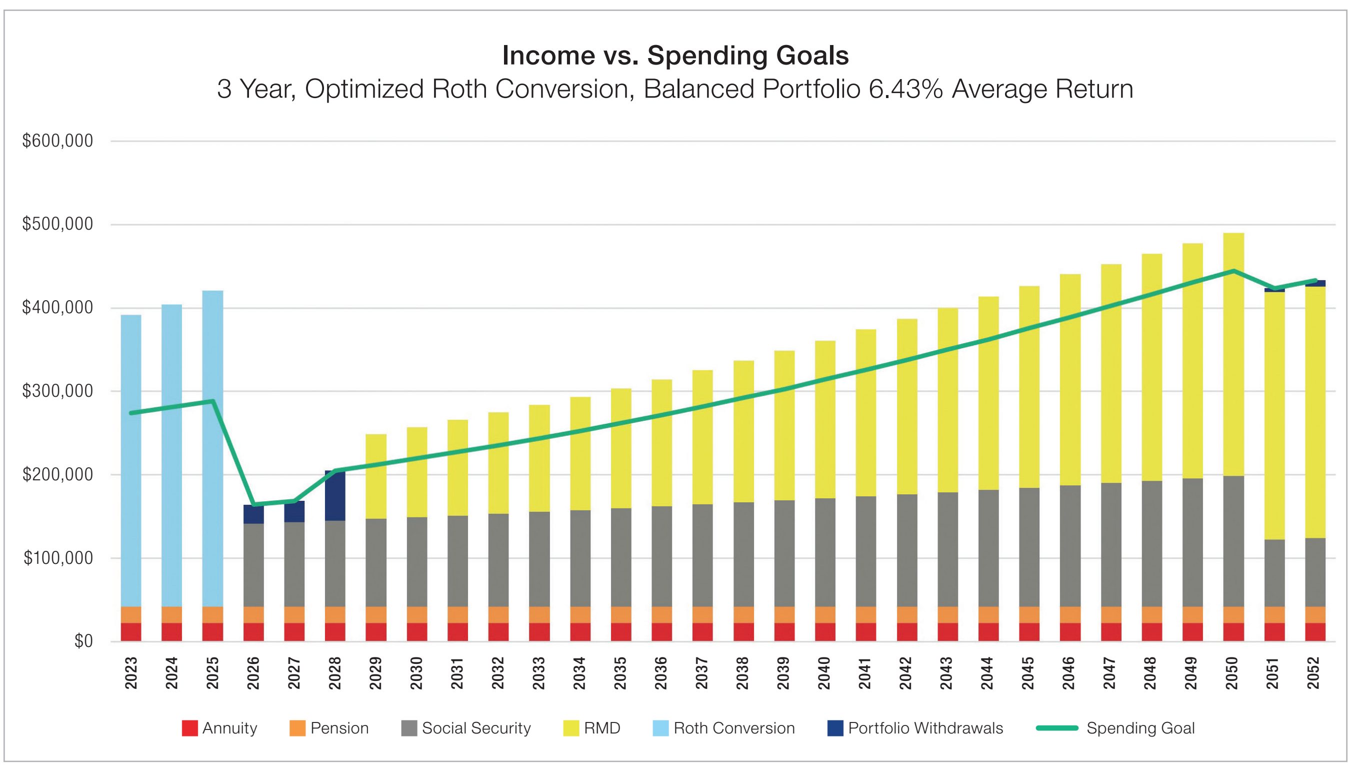
Created a tax-free Roth bucket valued at end of life $4,920,603

Asset Value	With Roth Conversion	Without Roth Conversion
Taxable	$3,455,786	$6,588,936
Qualified	$2,469,413	$3,779,655
Roth	$4,920,603	$0
Total	**$10,845,802**	**$10,368,591**

Asset Values at end of plan are in current dollars



Income above the green line is not needed



CASE STUDY

Highest Tax Bracket Now and Later

Planning challenge

Client is projected to have more taxable income than her projected spending in retirement. RMDs are projected to be significant when she turns RMD age, now for her at age 75.

Facts

Client is 60-years-old, projected age at death 96, single, female, retired. Current Net Worth $15 million. Current tax bracket 37%. Tax bracket reverts to 39.6% in 2026. Balanced Investment Objective projected average annual return 6.43%.

Solution

Take advantage of expanded tax brackets due to inflation, $655,000 Roth conversions for three years.

Result

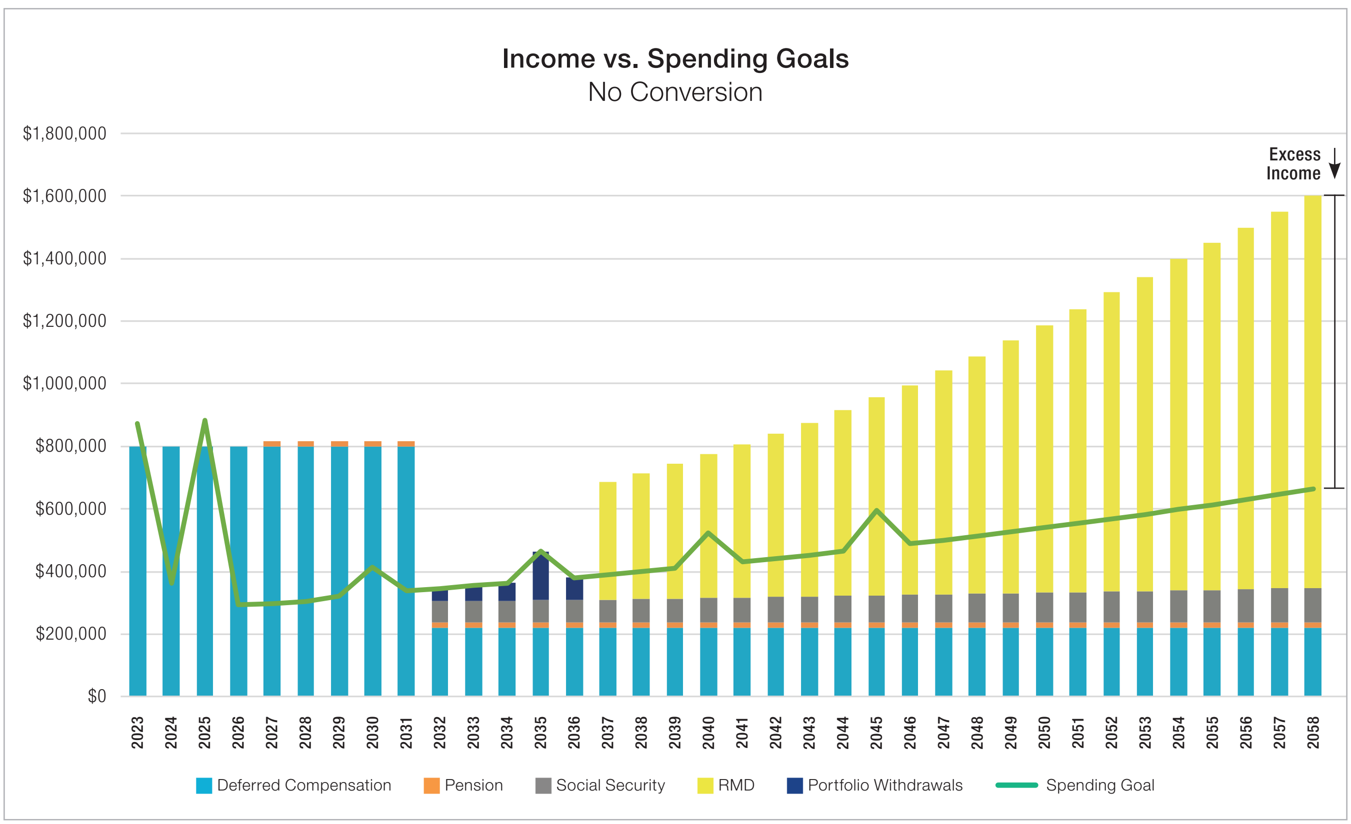
Total Estimated Lifetime Tax Saving $3,129,476*.

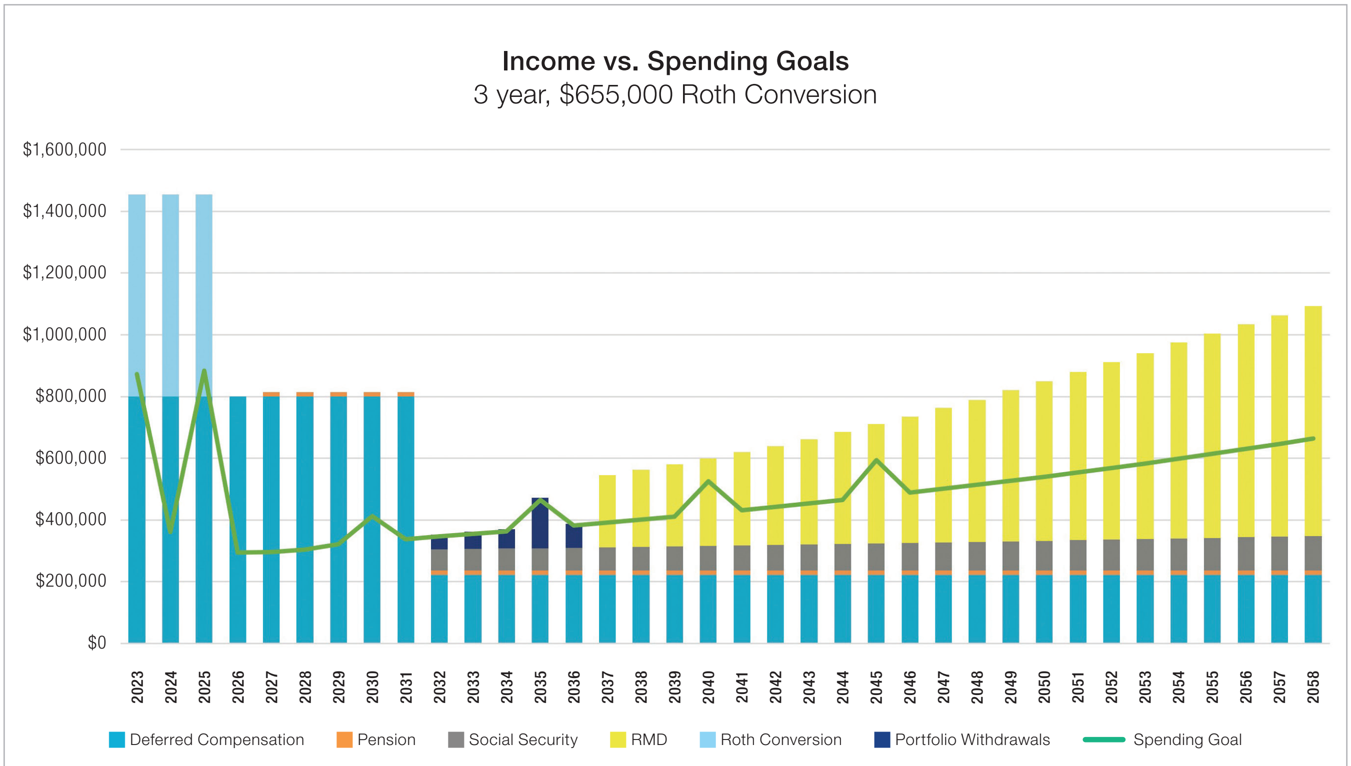
First year RMDs have been reduced by 38%

Created a tax-free Roth bucket valued at end of life $17,577,626

Asset Value	With Roth Conversion	Without Roth Conversion
Taxable	$27,134,074	$36,110,836
Tax-Free	$1,412,004	$1,412,004
Qualified	$7,063,235	10,226,867
Roth	$17,577,626	$0
Total	**$53,186,939**	**$47,749,707**

Asset Values at end of plan are in current dollars





The objective in this type of tax planning is to reduce your pre-tax retirement balances prior to RMD age to have more control over your tax liability. You do not want your RMD, combined with your other income sources, to cause you to receive income higher than your spending needs. Do not pay income taxes on income you do not need or want in retirement. Consider taking distributions before you reach age 73 to lower the overall value of your qualified retirement accounts, thus reducing the dollar amount your RMD will be based on when you do reach the mandatory withdrawal age.

As you get closer to year-end, determining your marginal tax bracket and projected investment income can be done with more certainty. If you are trying to convert your pre-tax dollars to Roth dollars to fill up a tax bracket, start those conversations now. Run all your tax calculations by a professional. You want to be sure not to push yourself into the next tax bracket.

*Assumes tax rates revert to the higher pre-Tax Cuts and Job Act rates in 2026.

Reasons not to covert to a Roth

If you will be in a lower tax bracket in future years

It is important to also evaluate how your state treats retirement distributions. For example, it doesn't make sense to pay state income tax on a Roth conversion if you are moving to an income tax-free state like Florida in retirement. Also, some states have special provisions as it relates to retirement distributions. You may be eligible for some state income exclusions based on your age and amount. A conversion prior to this age may be at a higher state tax cost then withdrawals taken in retirement. Even if you think tax rates will be higher in the future, consider whether you personally will be in a higher tax bracket.

If you don't have enough cash or savings to pay the conversion tax

It is not recommended to use part of your pre-tax qualified balance to pay the tax liability. If you pay the taxes from the traditional IRA, your new Roth IRA will have much less money in it. It is important to understand that money withheld from the conversion for taxes counts as an IRA distribution, if you are under age 59½, you will owe a 10% penalty on the withdrawal in addition to the income taxes.

If your beneficiary is a charity

A charity receiving these assets will not pay taxes for selling the assets and withdrawing them, therefore prepaying taxes by converting to a Roth doesn't make sense and it is likely the charity would receive fewer funds.

If you might need the money within five years

Each Roth conversion has its own five-year seasoning rule. Roth IRA withdrawal and penalty rules vary depending on the owner's age, how long they have had the account, and other factors.

For more information on how creating a Roth bucket might be appropriate for you and to discuss ways tax diversification and Roth planning can reduce your income tax liability over your lifetime, please contact your advisor.

About the Author

As a Relationship Manager for Key Private Bank, Gretchen focuses on ensuring her clients' wealth management plans are carried through to meet their unique financial objectives and grow and preserve wealth.

Gretchen coordinates the implementation of wealth management strategies with the relationship team and ensures clients have the tools and information to keep track of their financial situation and make informed decisions. She also coordinates regular communications and updates with the team, and proactively delivers the latest insights and advice to benefit clients' particular situations.

Gretchen has more than 30 years of experience in financial services and is well qualified to help clients implement strategies to achieve their goals. Most recently, prior to joining Key, Gretchen served as Director of Advanced Planning for Prudential Financial where she was a subject matter expert on financial and estate planning, and on retirement topics such as Social Security, Medicare and tax efficient distribution strategies.

Gretchen earned a bachelor's degree in Management from Springfield College and an MBA from the University of Phoenix. Gretchen obtained her certification as a Certified Financial Planner™. Most recently she obtained her Certified Divorce Financial Analyst® certification in 2023. She is a member of the Financial Planning Association, the Investments & Wealth Institute and the Institute for Divorce Financial Analysts®.

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