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"Income equality: where those who have produced nothing take from those who've earned it to give to those who haven't."

"Social justice: a system in which politicians forcibly collect from you what they think you owe others, even though others have provided nothing of value to you."

— Doug Thorburn, EA, CFP®

Tax and Financial Strategies

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Wealth Creation Strategies

Congratulations to Kristin Ericson, EA who passed all three parts of the Enrolled Agent exam this summer/fall and received her EA card from the U.S. Treasury Department in mid-December!

Buy a Car Every Five Year with the Tax Savings from (Self Created) "Income Averaging:"

Combine Deductible 401k and IRA Contributions with Taxable Roth Conversions

Income averaging, allowed from 1964 through 1986, was a statutory method of reducing the tax in a year in which taxable income increased substantially over that of previous years. The law allowed income to be "spread" over a several year period. The maximum tax rate you were subject to in that year artificially decreased, lowering the tax.

Statutory income averaging was never a perfect method. It required income to increase substantially over the three or four most recent years to result in any tax savings, and it didn't save tax for those whose incomes dropped or fluctuated wildly year-to-year. Because of this, I counseled clients to "smooth" their year-over-year taxable income (income minus deductions) whenever possible, taking self-created income averaging to a new level. Although more difficult to execute, it has always been more effective than the government's (now extinct) version in lowering overall taxes on lifetime income. Yet, while no other strategy decreases taxes over the long term as effectively as "smoothing" income, none is as misunderstood.

There are three reasons for this confusion. First, few understand the term "marginal," as in "marginal tax rates" and, as a result, its critical importance to decision making is widely under-appreciated. It is only the "marginal" rate that provides us the precise tax cost from an increase in the last "chunk" of income or the precise tax savings from an increase in the last "chunk" of deductions.* Tax decisions should be made by determining this marginal rate, taking into account the fact that different types of income and deductions are treated differently and may be taxed at different rates. Such decisions should never be made using "average tax rates," because "averages" do not determine the change in tax by altering the last "chunk" of income or deductions; averages provide zero useful information for making decisions.

Second, phantom but very real tax rates are all but ignored, even by other professionals. When I told another CFP® that a mutual client's IRA withdrawals would be subjected to 22.5%, 27.75% and 46.25% tax rates in future years if we didn't reduce her IRA balance via a series of Roth conversions, he argued with me over the very existence of those rates. He didn't want her to pay tax at a 15% rate now on the conversions when he thought she could pay at a 15% tax rate later; it took 15 minutes for him to acquiesce to the idea that she might be subjected to these higher phantom, but very real, tax rates in retirement because of the way Social Security benefits are added to the taxable base.

Third, most people are convinced that deferring taxes is always best. When given a choice of taking ("realizing") additional income this year vs. next year and, therefore, paying additional tax now vs. later, most people respond: "I'd rather defer the income and pay tax later." That can be a really bad idea.

A correct response requires us to raise additional questions. What is the time-frame over which tax will be paid? What is the category of income or deduction for which a choice is available?

What's the comparative *real* marginal tax rate each year, taking into account the multitude of possible phantom rates the various types of incomes are subjected to? For example, would you rather take an additional IRA withdrawal this year, when your last "chunk" of such income is taxed at 15% (your "marginal" tax rate), or next year when we expect your last "chunk" of income to be taxed at 25%? Put in this way, of course you'll choose to accelerate the income and pay tax this year at the lower rate. Likewise, if you have a choice between taking a specific deduction this year, in which your last "chunk" of deductions saves 15%, or next year, when your last "chunk" will save 25%, you'll (no-brainer!) defer the deduction. Think about it: you have a choice of paying $1,500 of tax this year or $2,500 next year on the same $10,000 of income or, similarly, saving $1,500 this year or $2,500 next year simply by shifting the same $10,000 deduction from one year to the other. In either case you save $1,000 by voluntarily paying an additional $1,500 of tax this year, for an extraordinary ($1,000 /$1,500 =) 67% return on your "investment."

Considering how few people view it from this perspective and the difficulty of being able to shift income and deductions from one year to another, even with such high returns it's not surprising that few taxpayers use this tax "arbitrage" strategy. You *might* be able to shift a few thousand dollars of state income tax or property taxes from one year to another, and perhaps several thousand more of charity if so inclined. Self-employed individuals may be able to shift business income (accelerate collections or defer billing) and expenses (buy business supplies or equipment this year rather than next year); many taxpayers can take a larger or smaller IRA or other pension withdrawal. Overall, profitably shifting income or deductions from one year to another requires fairly precise forecasts of taxable income year-over-year, difficult in practice even with our help. But the good news is, in 1998, such smoothing of taxable income, or self-created "income averaging," became much easier.

"Income averaging" without tears

Roth IRAs were created by the late Senator William Roth (R-VT) in 1998. Those with incomes below certain levels could contribute annually to Roth IRAs (up to $2,000 yearly back then). More importantly for our purpose, some taxpayers (now, anyone) could do "Roth conversions"—penalty-free transfers of funds from IRAs to Roth IRAs. Taxes are paid when the conversion is done, but avoided when distributions are made (and, done right, even the earnings avoid tax!). This self-created "income" allows the IRA owner to decide how much additional income on which to pay tax each year.

Anyone with a traditional IRA, including rollovers from 401ks and other retirement plans, can create additional income via Roth conversions and, if the result isn't satisfactory, undo part or all of the conversion the following year. This ability to "recharacterize" (undo) some or all of a Roth conversion when preparing tax returns eliminates the need for precise forecasts of taxable income, allowing fine-tuning of one's marginal tax rate up to the extended due date for filing the return. It's as if the portion undone was never converted—it's returned to the IRA and avoids tax. (Golfers call this a "mulligan.") This process can be repeated each year, minimizing taxes paid over a lifetime by allowing taxpayers to prematurely realize retirement income in low bracket years, either before or during retirement.

In addition, many taxpayers can reduce taxable income during the year by making 401k contributions and, even after year end, by electing to make prior year traditional IRA or non-401k pension contributions. Together, IRA/pension contributions, Roth conversions and 401k contributions lead to a largely unused combination strategy that can benefit taxpayers whose taxable income varies from year to year. Within limits, you're in the driver's seat in deciding the marginal rate at which you pay tax.

Let's look at a married couple whose income fluctuates from year to year by as much as $40,000. In some years the last $20,000 of income this couple earns is taxed at 25%; in other years, an additional $20,000 could have been realized on which they would pay a marginal rate of only 15%. What can such a couple do? They can "smooth" their income by combining 401k (or other retirement plan) and traditional IRA contributions *with* Roth conversions each year, saving thousands or even tens of thousands of tax dollars over time.

Let's say this couple's taxable income, not including 401k or IRA contributions, is estimated to be $92,500 in 2013, when joint filers' taxable income in excess of $72,500 is taxed at 25%. She invests the $17,500 maximum allowed for someone under age 50 into her employer's 401k, while he contributes $6,500 into an IRA, the new (2013) maximum for a spousal IRA for those age 50 and over. This results in expected taxable income of ($92,500 - $17,500 - $6,500 =) $68,500, dropping them into the 15% bracket. "Income" created via a Roth conversion of $4,000 (bringing taxable income up to $72,500) would "use up" the 15% bracket. Since we cannot be certain about the final figures until after the year is over, however, we suggest they convert $10,000. If our estimates are accurate they will undo (recharacterize) $6,000 of the Roth conversion by the extended due date of the tax return. If taxable income ends up being less than expected, we've got $6,000 of "extra" conversion—they may not have to undo any of it. If taxable income is a bit more than expected, we can "undo" more of the Roth conversion. In addition, she can contribute $5,500 to her Roth IRA (the maximum allowed for those under age 50), funneling even more money that would have gone into taxable savings to an account where investment earnings are permanently tax free.**

The following year, we expect this couple's taxable income to drop by $40,000, to $48,500. First, we suggest they continue to invest the maximum into her 401k. They could then convert $24,000 from a traditional IRA to a Roth IRA and stay in the 15% bracket; he could contribute $6,500 directly to a Roth IRA rather than to a traditional IRA. By essentially shifting $24,000 of income from the 25% to the 15% mar-

ginal tax bracket, the overall tax savings over the two-year period totals $2,400. If income fluctuates this much every other year for 20 years, this "income smoothing" strategy will save $24,000 in *tax* over a 20-year period. If the $2,400 savings realized every other year is invested at 5% over the 20-year period, the overall profit from the strategy would be more than $42,000 ($2,400 every other year plus the growth for 20 years).

For those with plenty of funds in taxable (non-retirement) investment accounts, we not only "average" the income, but also funnel money from taxable accounts into traditional IRAs and 401ks and, ultimately, Roth IRAs. Because investment income earned inside Roth IRAs (done right) is never taxable, this strategy yields additional long-term tax savings.**

For example, someone able to funnel $15,000 per year for 20 years from taxable investment accounts ultimately into Roth IRAs using this "funneling" technique will end up with $300,000 in Roth IRAs which, at "normalized" (long-term average) returns of 5% per annum, would yield ($300,000 x 5% =) $15,000 of tax-free earnings yearly. Shifting this $15,000 of income from taxable accounts to Roth IRAs could also shave $5,000 per year off a tax bill for years or even decades. Combining this strategy with the Roth conversion strategy above (which, in our example, yields $42,000 over 20 years, averaging $2,100 per year) would pay for a very nice pre-owned car every five years ($5,000 plus $2,100 yearly tax savings yields $35,500 in five years). Smoothing income is a long-term tax-saving strategy unlike any other, and many of you have been doing this for years with our guidance. Others have an occasional two- or several-year period over which such income shifting may be quite profitable. So, tell us whenever your income or deductions are expected to materially deviate from the previous year and ask whether these strategies might work for you—but be sure to contact us *before* the year is over!

* To calculate the marginal tax rate, divide the tax cost on the last "chunk" of income by that income, or the tax savings on the last "chunk" of deductions by those deductions. For example, if you're deciding whether and how much to contribute to an IRA, your average tax rate of 12% is irrelevant. You calculate that a $2,000 contribution to your IRA will shave $600 off your tax bill; that's a hefty ($600/$2,000 =) 30% savings. If an additional $3,500 contribution saves $525 in tax, the reduction is only ($525/$3,500 =) 15% on that last "chunk" of deductions. While not the only factor to consider, this is instrumental in helping us decide you should probably contribute $2,000 to your IRA and $3,500 to your Roth IRA.

** Once certain holding requirements are met, earnings are tax-free for those over age 59 ½. There are no holding requirements of principal for those doing Roth conversions who are at least age 59 ½ and who made their first Roth contribution or did their first Roth conversion at least five years earlier.

Timely Financial Quotes

"All of us would like to observe lower unemployment, but the belief that quantitative easing will materially contribute to this outcome is unsupported in both theory and evidence. The present course of Fed policy is destabilizing the global economy by contributing to a financial environment that encourages the allocation of scarce savings toward speculative activity, not productive investment. When 'QE' and the 'Bernanke put' are the sole focus of the financial markets–not productivity, not innovation, not sound policy options, not careful intermediation of capital, and certainly not the plight of the elderly that have been starved of interest income–it should be obvious that things have gone too far.

"This experiment has played out long enough….and it sows the seeds of the next collapse. The Fed is stepping on a gas pedal in the hope of making the wheels go faster, and instead the gasoline is spurting out of the tank and feeding speculative flames…."

— John Hussman, "Weekly Market Comment," May 27, 2013

"[Federal Chairperson nominee Janet Yellen, like her predecessor Ben Bernanke,]…believes in rampant money printing. In fact, in recent years, Yellen has been one the most forceful advocates for Quantitative Easing. That's why everyone on Wall Street [was delighted that] Obama [nominated] her.

"How about her belief in free markets? Well, back in 1999 she said: 'Will capitalist economies operate at full employment in the absence of routine intervention? Certainly not.' That means she believes in heavy intervention from the Fed and thinks that, somehow, money printing will create jobs. [The amount of money in circulation has nothing to do with the creation of jobs.]

"She is also incompetent in economic forecasting. Back in February 2007, before the housing crash and the global credit crisis, she said this about the housing market:

'The concerns we used to hear about the possibility of a devastating collapse–one that might be big enough to cause a recession in the U.S. economy–while not fully allayed have diminished. I think there is a reasonable chance that housing is in the process of stabilizing, which would mean that it would put a considerably smaller drag on the economy going forward.'

"Just like Bernanke, she failed to foresee the crisis. She actually admitted her failure in 2010, when she testified in front of the Financial Crisis Inquiry Commission. In that occasion, she said: 'I did not see and did not appreciate what the risks were with securitization, the credit ratings agencies, the shadow banking system–I didn't see any of that coming until it happened.'

"That doesn't exactly inspire confidence now, does it?"

— Evaldo Albuquerque, "Prepare for the Yellen Collapse," *The Sovereign Investor*, September 23, 2013

Roth IRA Contributions: Creating Tax-Free Retirement Income

Because Roth IRAs earn otherwise taxable investment income completely tax-free, they may be the best tax shelter extant. The following chart from issue # 51 of *WCS* reflects maximum allowable contributions by year.

Maximum Allowable Contributions to Roth IRAs by Year

Year	Age 49 and Below	Age 50 and Above
1998-2001	$2,000	$2,000
2002-2004	$3,000	$3,500
2005	$4,000	$4,500
2006-2007	$4,000	$5,000
2008-2012	$5,000	$6,000
2013	$5,500	$6,500

Total maximum contributions to Roth IRAs through 2013 are $59,500 for those who haven't yet reached age 49 and $69,500 for those who have been over age 49 since their inception.

What might such a series of regular investments provide in tax-free retirement income? Simply calculate the tax-free earnings. We failed to include a chart reflecting this hypothetical tax free growth, which shows *how* and *why* the Roth may be the best of all possible shelters. This omission is corrected here.

Tax-Free Earnings after 16 and 26 Years of Roth Contributions with x% of Growth

		5% Annual Growth		10% Annual Growth	
		Under age 50	**Age 50 and over**	**Under age 50**	**Age 50 and over**
Total allowable contributions 1998-2013		$59,500	$69,500	$59,500	$69,500
After 16 years of maximum Roth IRA contributions	**Account value 12/31/13**	$81,560	$94,295	$115,080	$132,041
	Future tax-free income*	$22,060	$24,795	$55,580	$62,541
After 26 years, with 16 years of maximum Roth IRA contributions (no contributions after 2013)	**Account value 12/31/26**	$153,794	$177,807	$397,287	$455,841
	Future tax-free income*	$94,294	$108,307	$337,787	$386,341
After 26 years of theoretical maximum Roth IRA contributions**	**Account value 12/31/26**	$256,086	$298,698	$545,650	$631,179
	Future tax free income*	$125,086	$144,698	$414,650	$477,179

* Meeting easy-to-follow rules before withdrawing funds, total Roth IRA value less after-tax contributions.
** Assuming $5,500 yearly contributions ($6,500 for those age 50 and over) after 2013.

These amazing returns don't mean Roth IRAs should be the sole retirement vehicle for everyone. Most workers and retirees should have a combination of both Roth IRAs and pre-tax retirement accounts. However, the next article demonstrates that low income, low net worth individuals nearing retirement may realize a substantial tax savings by making deductible IRA contributions while in low tax brackets because they will be afforded the opportunity to pay tax on withdrawals at even lower rates. For many, the tax rate could be zero on a large chunk of retirement income.

Which is Better for Maximizing Income for Future Low Income Retirees: Traditional or Roth IRAs?

"Which IRA should I invest in?" has no "one-size fits all" response. It depends on many factors, including current pre-tax retirement fund balances, future expected pension payments, other expected retirement income, future inheritances, current tax rates, future tax rates, expected life-spans, current and future marital status, state of residence now and later, as well as nearly countless phantom (hidden but *very* real) tax rates buried in the tax code. When we advise where retirement contributions should be made, we view each situation from a variety of angles. There are general rules, the most important of which is pre-tax retirement contributions should be made by those in a 25% or higher tax bracket and after-tax (Roth IRA) contributions should be made by those in the 15% or lower tax bracket. However, because situations vary so greatly there are countless exceptions to and variations on even this fundamental rule.

One such exception crystallized when a new client, whose combination of income and deductions places him in the 15% tax bracket every year, mentioned he previously converted all of his IRAs to Roth IRAs and now makes contributions only to the latter because he hopes to avoid paying *any* tax when he retires. When I suggested he might want to do the opposite and earn at least some taxable income in retirement—and that doing so would save a tremendous amount of tax in the long run—he was flummoxed.

I explained that single retirees age 65 and over pay no tax on at least the first (roughly) $11,000 of non-Social Security income per year ($22,000 for married retirees). Therefore, you *want* to have at least that much non-Social Security income in retirement if in creating such income you save or avoid paying tax now at any rate greater than zero, as long as your Social Security benefits will be subjected to little or no tax (depending, of course, on the particular situation). After realizing what he'd done, his eyes widened and he exclaimed, "Oh crap."

We've got a number of 50-something working clients in the 15% tax bracket with little socked away in IRAs and 401ks who anticipate modest Social Security benefits and little or no other taxable income in retirement.* While we generally don't suggest they invest in traditional IRAs at the 15% tax bracket, we often do in these cases (depending on a multitude of other factors).

Let's say IRA and 401k contributions were deducted at the 15% bracket (with tax on the growth of the IRA avoided at that rate) during the accumulation (working) phase. Let's assume you end up with $200,000 in pre-tax (IRAs, 401k, etc.) retirement accounts at age 66 and earn 3% per annum. You'll be able to withdraw $10,000 per year, receive Social Security benefits and *never* pay income tax before running out of funds just past year 30. Congratulations: you just permanently avoided $30,000 of income tax on more than $300,000 ($10,000 per year for more than 30 years with 3% growth) of IRA withdrawals!**

The same IRA account owner, who wants the funds to last only until age 83 (the average life expectancy at age 66), can withdraw $14,400 yearly and pay a 10% tax on only $3,000 per year ($14,400 less the current $7,500 standard deduction for those age 65 and over and $3,900 personal exemption). The tax bill over 18 years will total about ($3,000 x 18 x 10% =) $5,400; ($30,000 - $5,400 =) $24,600 in tax is permanently avoided on nearly $260,000 of withdrawals! Except for having to pay additional tax if Social Security benefits are partly added in to the taxable base (which can occur if Social Security benefits are large enough or there is other income), married filers with $400,000 in pre-tax retirement accounts can double these tax savings.

Those eligible to deduct the cost of assisted living, nursing care or hospice may avoid tax on substantially more income. Large out-of-pocket medical costs are the most common reason retirees itemize deductions, unfortunate though it is, as Medicare doesn't cover such expenses. With $40,000-$70,000 in out-of-pocket medical costs yearly, $30,000 to $60,000 per year can be withdrawn from retirement plans tax-free; it's not equal because of limitations on medical deductions and it can vary tremendously depending on the amount of Social Security benefits added to the taxable base. Even if traditional IRA and other retirement account contributions were deducted at low tax rates, taxpayers in this situation may save an enormous amount of tax in the long run. The problem is those without long-term care insurance (which few people own***) have no way of knowing whether they will ever be in a position to take tax-free IRA withdrawals due to medical deductions. This leaves the decision of how much and for how long to keep funds in pre-tax plans to educated guesswork.

This uncertainty is also a good reason to avoid zeroing out pre-tax IRAs during retirement. You *want* to have enough annual income to offset medical (and other) deductible expenses. Itemized deductions are wasted whenever medical and other deductions exceed income (you generally can't carry them over to another year). One of my overarching tax philosophies is to do everything possible to avoid such excess deductions. However, while we want to avoid taking income at even 10% tax rates earlier in life if we find later we could have realized additional income at 0% tax rates when medical expenses are inordinately high, all we can do is to hope for the best.

* Many of these individuals purchased their home decades ago and own it outright, in at least one instance paying off a mortgage with the life insurance proceeds from a spouse's early death. Others live with or are helped by parents, whose non-mortgaged homes they will inherit. I suspect at least one pulled a "John Galt" and purposely lives modestly.

** The effect of the low-income savers' retirement credit, which applies equally to Roth and traditional IRAs, is not included in this analysis; because it greatly complicates decision-making, suffice it to say there are numerous occasions where part Roth and part traditional IRA are recommended.

*** Whether such insurance is worth the cost is a very mixed bag. Even those who have coverage may end up paying their own long-term care costs after several years due to a cap on most policies' benefits.

I Need Extra Funds for Splurging. Should I Withdraw from My Roth IRA or Taxable (Non-Retirement) Investment Account?

Dear Doug,

My wife and I generally have enough income from pensions, Social Security, taxable investment accounts and mandatory IRA withdrawals to survive handily; we also have Roth IRAs from which we are not currently taking withdrawals. However, we are thinking about splurging a bit and need an additional $20,000 annually for accoutrements of retirement (mainly cruises and gifts for the kids and grandkids). We previously decided, per your advice, against taking additional withdrawals from our traditional IRAs (even if we should, as you've explained, convert some of the IRA every year to a Roth IRA), because we would pay a 25% marginal tax on additional IRA withdrawals. This leaves only two sources from which to draw: Roth IRAs and taxable investment accounts. From which should we take the $20,000 extra each year?

Signed, Confused Retiree

Dear Happy Retiree,

Given the choice of withdrawing from Roth IRAs or taxable investment accounts, I can't imagine a situation in which Roth funds should be used before depleting taxable accounts. Funds in taxable accounts earn investment income (interest, dividends and capital gains) on which tax is paid each year. Funds left in a Roth account earn income tax-free, once you have met the easy-to-meet rules (which you have met). Because you can invest in identical investments, you can earn identical returns in both taxable investment accounts and Roth IRAs. Therefore, it's a no-brainer: you should always spend taxable funds first.

Look at it this way: say you have $200,000 in your taxable investment account and $200,000 in your Roth IRA. (The actual amounts are irrelevant, since the idea applies regardless of amount.) We'll assume the accounts are invested identically, as nearly any "normal" investment that you can make in a regular taxable account can also be made in a Roth IRA; you earn an average of 5% on the remaining balances in both accounts. We'll also assume that each account earns an identical combination of interest and short term capital gains (normally taxed at 25%) and qualifying dividends and long term capital gains (normally taxed at 15%) averaging 20% in taxes on the earnings in the taxable investment account. Let's say you decide to withdraw the entire $200,000 at once. From which should you withdraw funds first? The Roth IRA, leaving the taxable investment account on which you pay $2,000 in tax on the $10,000 yearly investment income, or from the taxable account, letting the Roth IRA earn permanently tax-free income? Obviously, since you'll save $2,000 per year in tax—$20,000 over the course of a decade—the Roth IRA is the *last* place from which you want to withdraw funds.

Since you don't need the wad all at once, let's consider this from a longer-term perspective by comparing two long-term strategies: a $20,000 annual withdrawal from the Roth IRA vs. a $20,000 annual withdrawal from the taxable account.

A $20,000 annual withdrawal from your Roth IRA earning 5% on the remaining balance will fully deplete it in 13.9 years (option 1, below). In the meantime, the taxable investment account will grow to about $345,000, after taxes, in 13.9 years.

Alternatively, a $20,000 annual withdrawal from the taxable account (option 2, below) fully depletes that account in 12.8 years. While you lose a year of withdrawals, using the same growth assumptions you end up with more than $373,000 in the Roth account at that point. This is $28,000 more ($373,000 - $345,000) in remaining cash than you end up with in the taxable account by withdrawing from the Roth first. Assuming you continue to earn 5% and at the 12.8-year mark begin withdrawing $20,000 per year from the Roth IRA, you'll withdraw very little principal in the early years ($373,000 at 5% earns $18,650 annually; only $1,350 in principal is withdrawn in the first year). Using option 2, the Roth IRA account balance won't even drop to $345,000 for another 14 years. Under this option, you still have $275,000 in your Roth IRA when, 29.3 years after you've depleted your Roth IRA under option 1, that option's taxable investment account would be depleted. Using option 2, your Roth IRA won't be gone for yet *another* 24 years. While you might not live so long, your heirs just could—and you will have increased the net income to both you and your heirs by about ($1,080,486 - $864,339 =) $216,000 over that extended time frame.

The Long-Term Wealth Creation Benefits of Spending Non-Roth IRA Funds First

Year	Option 1: $20,000 Yearly Withdrawal from $200,000 Roth IRA First		Option 2: $20,000 Yearly Withdrawal from $200,000 Taxable Investment Account First	
	Roth IRA Balance, Remainder Grows at 5% Yearly	Investment Account Balance, 4% After-Tax Net	Invest Account Balance, Remainder Grows at 4% After Tax	Roth IRA Balance, 5% Yearly Growth
1	$189,768	$208,000	$187,777	$210,000
2	$179,012	$216,320	$175,057	$220,500
3	$167,705	$224,973	$161,818	$231,525
12.8	$17,408	$330,413	$0	$373,000
13.9	$0	$344,980		$372,000
43.2		$0		$277,000
67.2				$0
Total $s withdrawn	**$864,339**		**$1,336,325**	

Because of the tax-free growth of your Roth IRA, it's the last of your savings you should consume. And even if you never spend it, the remaining balance is inherited income tax free and, because estate tax only hits if net worth exceeds $5.25 million (plus an annual inflation adjustment), very likely estate tax free. What better gift for your loved ones?

We'll Be in the Same Tax Bracket for the Rest of Our Lives. Why Should We Do Roth Coversions?

Dear Doug,
My wife and I, newly retired, have taxable investment accounts and an IRA. We want to enjoy our retirement now. Why in the world would we consider a Roth conversion when we think our tax bracket will be the same later as now? Why not defer the tax, as others have always told us to do?
Signed, Tax Averse

Dear Averse,
Whether you should do Roth conversions depends largely on your marginal tax bracket now and later. If you're in a higher bracket now than you expect to be later in life, a Roth conversion *may* make no sense. If you're in a lower bracket now than you reasonably expect to be in later, paying the tax now at lower rates is much more sensible and profitable than paying the tax later at higher rates, especially if in doing so you transfer the funds to a Roth IRA, where earnings (assuming you comply with the easy-to-meet rules) grow tax-free.

But first, even if you don't think it's likely, your retirement income may be subject to higher tax rates later. This may not occur while both of you are alive, but the survivor will probably be slammed at higher rates for several reasons. As a couple you can earn up to $72,500 (2013 amount) of taxable income at the 15% nominal (advertised) tax rate; the survivor will be able to earn only half of that before being subjected to the 25% nominal tax rate. Married filers can earn up to $146,400 in taxable income at the 25% tax rate before succumbing to higher rates; the survivor is subject to higher rates once taxable income exceeds $87,850. Assuming both of you are age 65 or over, your standard deduction and personal exemptions allow $22,400 (in 2013) of tax-free income; the survivor gets only half of that tax free. As a couple, Medicare premium surcharges begin at modified Adjusted Gross Income (AGI) of $170,000; this figure is $85,000 for individuals (fixed, unadjusted for inflation, by the purported health care act until at least 2018).* Worst of all, while few married couples are subjected to a phantom 46.25% tax on a chunk of income because of the way Social Security benefits are added to the taxable base, *many* single survivors pay tax at that confiscatory rate on a larger chunk of income, and sometimes even higher due to phase-outs of other deductions and tax benefits.

And of course, tax rates may increase if only because of politicians' drunken spending sprees, which have doubled federal government debt in the last five years (now $17 trillion on the books and at least $100 trillion off the books). Ultimately, the piper must be paid.

Surprisingly, however, Roth conversions are profitable even if your tax bracket never changes, so long as taxes on the conversion are paid with taxable (non-retirement) funds.

Let's have you do a $50,000 Roth conversion, just enough to nearly "use up" your 25% tax bracket but not quite enough to subject you to a Medicare

premium surcharge. To simplify, we'll assume you have only $50,000 in the IRA and $12,500 in a taxable investment account, and because some of your earnings on investments are qualifying dividends and long-term capital gains, your weighted average marginal tax rate on investments is 20%. We'll compare the results of paying the 25% tax ($12,500) out of your investment account with paying the tax out of the IRA, as well as not converting at all.

Converting the full $50,000 and paying the tax from your taxable account (option 1, below), at 5% annual growth the $50,000 Roth grows to $81,445, $132,665 and $169,318 after 10, 20 and 25 years, respectively. There is nothing left in the taxable account because you depleted it when you paid the tax on the conversion. Since Roth distributions done right are 100% tax free, these figures are after-tax dollars to both you and your heirs.

If instead you don't convert (option 2, below), your IRA grows to the same amounts as the Roth above, except you must pay tax on withdrawals. This leaves, after tax at the 25% rate we're assuming, $61,084, $99,499 and $126,989 after 10, 20 and 25 years, respectively. The $12,500 "side fund" in the non-retirement account grows, after a 20% tax bite, to $18,503, $27,389 and $33,323, respectively. The totals in both accounts after 10, 20 and 25 years are $79,587, $126,888 and $160,312, respectively. By converting at the 25% bracket and paying tax out of non-retirement funds, your net worth is $1,859, $5,779 and $9,008 greater than by not converting after 10, 20 and 25 years, respectively. Consider the increased net worth if you engage in a series of similar conversions over a ten-year period, assuming the same tax bracket, as well as the tax savings if your marginal rate increases, as will almost assuredly occur after one of you dies.

Converting $50,000 but paying the $12,500 tax from the conversion (option 3, below) leaves $37,500 after tax for the Roth IRA, which grows to $61,084, $99,499 and $127,989 after 10, 20 and 25 years; the taxable account of $12,500 grows, after tax, to $18,503, $27,389 and $33,323 respectively. Note these are identical numbers to those in the paragraph above in which a conversion wasn't done. You end up with the same, lesser amount by not converting and paying the tax from the IRA as by converting initially and paying the tax from the IRA: $79,587, $126,888 and $160,312, respectively. If your marginal tax bracket is the same now and later, the advantage of paying the tax for your Roth conversion out of a "side fund" non-retirement account is that more principal is left in the Roth IRA to grow tax-free.

Advantage of Doing a Roth Conversion, Paying Tax from Non-Retirement Assets

	Account balance based on tax strategy; assumes $12,500 "side fund" taxable account			
# Years of growth	**Option 1:**	**Option 2:**	**Option 3:**	**Option 1 vs. 2/3:**
5 % per year before withdrawal	**$50,000 Roth conversion; pay 25% tax from taxable account**	**No conversion; Pay tax from IRA proceeds later; let taxable account grow at 4% after tax**	**$37,500 net Roth conversion after paying tax from IRA; let side fund grow at 4% after tax**	**Net profit by paying tax on Roth conversion from taxable account**
10	$81,445	$79,587	$79,587	$1,898
20	$132,665	$126,888	$126,888	$5,777
25	$169,318	$160,312	$160,312	$9,006

* Once modified AGI exceeds these figures, $672 is added to each person's Medicare Part B and D premiums two years later. The premium increases in "spurts" as modified AGI exceeds higher thresholds. The add-on premium can be as high as an additional $4,044 per person per year for those with modified AGI exceeding $214,000 for single taxpayers and $428,000 for joint filers. "Modified" AGI includes otherwise tax-free municipal bond interest income, as well as several more esoteric items.

Errata

In the last issue of *WCS*, pages 1-2, we mentioned that the phase-out of personal exemptions and itemized deductions adds less than 2% to the marginal tax rate. This would be correct if personal exemptions were phased out one at a time, as I originally thought; instead, they are phased out concurrently, so that for *each* personal exemption the phantom but very real tax rate increases by about .7%. For every $2,500 of AGI over $250,000 ($300,000 for joint filers) 2% of each exemption is phased out, which works out to be $50 per exemption. Married taxpayers with two dependents, then, lose $200 in deductions for each $2,500 of income over $300,000; at $400,000 AGI they've lost $8,000 in personal exemptions deductions (out of a total of $15,600), which at a 35% nominal marginal tax rate adds a very real 2.8% to their tax rate on top of a roughly 1% add-on rate for loss of itemized deductions. This turns a 35% tax rate into a nearly 39% rate.

In addition, we failed to mention some extraordinary penalties in our latest table of marriage penalties, along with some gruesome marginal tax rates with regards to the purported health care act. Ms. Pelosi famously said, "We have to pass the bill for you to find out what's in it." We're still trying to figure out all of the marriage penalties and confiscatory marginal tax rates the bill created. We'll pass along our insights later in the year.