T. ROWE PRICE INSIGHTS
ON RETIREMENT

When to Consider a Roth Conversion

This strategy could reduce your taxes over the long term.

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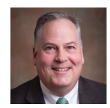
KEY INSIGHTS

- A Roth conversion—moving assets from a Traditional IRA to a Roth IRA—is most compelling when you pay tax on the converted amount at a relatively low rate.
- Converting assets early in retirement before you face required minimum distributions (RMDs) can reduce those RMDs (and the risk that they will increase your tax rate).
- Since a Roth conversion increases taxable income, in the conversion year, drawbacks can include: a higher tax bracket, more taxes on Social Security benefits, higher Medicare premiums and lower college financial aid.



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Since 2010, all investors have been allowed to convert assets from a Traditional IRA to a Roth IRA.[1] Because conversions are not subject to income restrictions, people at any income level can take advantage of the Roth's key benefit—tax-free qualified distributions.[2]

A Roth conversion provides you with tax diversification in your retirement years. In addition, Roth IRAs do not have required minimum distributions (RMDs) for the original owner, whereas Traditional IRAs are subject to RMDs after you reach age 70½. These positives need to be weighed against the tax you pay on the amount converted.

Deciding whether a Roth conversion makes sense in your situation depends on several factors, including:

- Your current and future tax rates,
- Your mix of assets, and
- Possibly your heirs' future tax rates.

Before you execute a Roth conversion, you'll also want to consider:

- How you will pay the taxes on the distribution,
- Timing of the conversion in relation to your retirement horizon, and
- Whether you are planning to use the money converted or planning for it to be used by your heirs.

[1] It may also be possible to convert assets from pretax to Roth within a retirement plan such as a 401(k). While many of the planning principles are the same, this paper focuses on conversions of IRAs.
[2] Generally, a distribution is qualified if taken at least 5 years after the year of your first Roth contribution and you've reached age 59½.

> Consider Roth conversions as part of your retirement income strategy, along with Social Security and investment account decisions.
>
> — **Roger Young**
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Advantages of Converting to a Roth

You can benefit from a Roth conversion by paying taxes now at a lower rate if your tax rate is likely to be higher when you take distributions. The strategy should be considered in a number of situations, if you are able to pay the taxes (preferably from a nonretirement account):

- Your current income is unusually low.
- You plan to leave the assets to heirs whose tax rates will be higher than yours.
- Your assets are primarily in tax-deferred accounts and you want more tax flexibility.
- You want more opportunity to optimize asset location—holding different types of assets in different accounts.
- You want a hedge against higher statutory tax rates. (For example, following the tax cuts passed in late 2017, you might believe that tax rates are unlikely to be any lower during your lifetime.)
- You won't need your RMDs for retirement expenses. As we will discuss further, even if your tax rate stays flat or decreases in retirement (despite the RMDs), a Roth conversion could be beneficial if you pay the taxes from an account that isn't highly tax efficient.

Disadvantages of Converting to a Roth

The key disadvantage of a Roth conversion is taxes due on the converted value. There are a number of reasons your tax rate may be lower when you (or your heirs) take distributions:

- Many people have lower income in retirement.
- When you take retirement distributions, they may represent a large portion of your income and straddle tax brackets, resulting in a lower average tax rate. (In contrast, the conversion probably adds to the income taxed primarily at your marginal, or highest, rate.)
- Some states don't tax retirement distributions, or have no income taxes at all, which is important to consider if you might relocate.

There are also factors to consider specifically for the year of conversion. Higher taxable income that year could have one or more of these negative effects:

- A higher tax bracket,
- A higher portion of Social Security benefits subject to tax,
- Higher Medicare premiums, and
- Less eligibility for student financial aid.

Strategies for Paying Taxes on a Conversion

In general, a conversion works best if you can pay taxes from a taxable account. Selling assets in a taxable account may be all or partly a return of your principal (cost basis) and, therefore, not be a taxable gain. Realized gains from those sales may be taxed at the long-term capital gains rate, which is typically lower than your marginal ordinary income tax rate. If you're considering this approach, make sure that you still have an adequate emergency fund and that this doesn't inordinately reduce your financial flexibility.

You could also pay the tax using distributions from the Traditional IRA or from existing Roth assets. In both cases, you could pay a penalty on the distributions if you're under age 59½. Funding the tax from a Traditional IRA would incur ordinary income tax on that distribution, so unless you're in a low tax bracket, that's not ideal. Using an existing Roth to pay the taxes doesn't result in ordinary income tax, but this approach essentially reduces the amount and the value of the conversion.

When is the Right Time to Convert Assets?

A Roth conversion is most compelling when you pay the tax on the amount converted at a low rate. So if your income is irregular, consider Roth conversions in low-income years. Or you could consider a conversion in a year when you've been unemployed. Unfortunately, those years may coincide with cash flow challenges, making extra tax payments impractical. But if you have lined up new employment without falling below a prudent cash level, a conversion could make sense.

Another common example is converting assets early in retirement before you face required minimum distributions. As noted above, be careful about triggering higher taxes on Social Security benefits or higher Medicare premiums in the conversion year. However, reducing your RMDs could have a favorable impact on Social Security taxation or Medicare premiums later. Ideally, you should coordinate your Social Security claiming strategy and retirement income strategy, including the account drawdown order and possible Roth conversions.

Running the Numbers—Evaluating Different Scenarios

We analyzed a situation in which a Roth conversion may make sense: Traditional IRA assets that won't be needed for retirement income are available, and a taxable account exists to pay the tax upon conversion. In this situation, the assets are intended to pass to heirs (in the next generation, as opposed to between spouses). A person in this position can use a series of annual Roth conversions to reduce unwanted RMDs.[3] Within this framework, we evaluated scenarios with a focus on three key parameters:

- Tax characteristics of the taxable account used to pay taxes on a conversion,
- Tax rate during working years versus in retirement, and
- Potential tax rate of your heirs.

The first of these parameters merits some explanation. Returns in a taxable account can generally be treated in one of three ways for federal income tax: ordinary income (e.g., interest received), capital gains (profits from the sale of securities), and tax-free (e.g., interest for certain municipal bonds). In addition, if you hold appreciated securities until death, your heirs can benefit from a "step-up" in cost basis. That means that they don't pay capital gains taxes on appreciation through the date of your death, so those gains are also essentially tax-free.

For each combination of these parameters, we measured the results of three strategies:

- No Roth conversion,
- Roth conversions each year from age 55 to age 70, and
- Roth conversions each year from age 65 (retirement) to age 70.

Each strategy is measured by the total after-tax asset value received by heirs upon the owner's death (assumed to be age 95). This value assumes that Traditional IRA assets are taxed upon death at the heirs' ordinary tax rate. (Roth and taxable accounts are assumed to pass to heirs income tax-free.)

We evaluated 12 combinations of assumptions for the three key parameters. Other assumptions were held constant for all scenarios.[4] We didn't analyze

[3] This analysis builds upon T. Rowe Price's February 2015 paper by Judith Ward CFP®, "How to Minimize Unwanted RMDs Using a Roth IRA Conversion Strategy."

[4] Assumptions for all cases: A married couple has an annual household income of $200,000 and is in the 24% federal tax bracket. The income level is such that Roth conversions ($40,000 annually during the relevant years) do not change their federal tax bracket. State income taxes are not considered. (This approximately reflects the state tax rate not changing from working years to retirement.) The couple has $500,000 saved in Traditional IRAs that they do not expect to need for retirement income. The fact that they have other income sources is important, but the analysis does not need to reflect those assets or cash flow streams. One spouse contributes $7,000 annually to a Traditional IRA from age 55 until age 65. The couple also has $130,000 in a taxable account that can be used to pay taxes on the Roth conversion (using assets without gains, so there is no additional tax due to liquidation). This account will also be used to invest RMDs from the Traditional IRAs (since RMDs are not needed for retirement spending). All accounts have 6% annual investment returns, before taxes. All capital gains are taxed at the 15% rate. RMDs are assumed to be taxed at the marginal rate (not across multiple tax brackets), which stays steady through retirement.

situations where the worker's tax rate increases during retirement, because those are generally advantageous for Roth conversions. Again, the idea was to depict a situation in which Roth conversion is plausible but not a "slam dunk."

Key Findings

1. In this broad situation (in which the IRA assets aren't needed for retirement spending), the benefit of a Roth conversion is driven largely by the profile of the taxable account being used to pay taxes on the conversion. If the taxable account is primarily generating ordinary income or even capital gains, Roth conversions are usually beneficial in the general situation we studied. (See dark blue and bright blue rows in Figure 1.)

2. There are situations in which a Roth conversion doesn't add value. (See dark gray rows in Figure 1.) This occurs if the taxable account generates tax-free returns and the person's tax rate in retirement (and/or the heirs' tax rate) is lower than during working years.

3. If converting makes sense, you generally get much more benefit by starting sooner (and, therefore, converting more). Alternatively, you could convert the same total amount over fewer years, but you'd be more likely to jump into a higher tax bracket.

The importance of the taxable account profile may seem counterintuitive. After all, the conversion is from a Traditional IRA (pretax) to a Roth, and the taxable account seems like a secondary factor. In general, however, Traditional and Roth IRAs have equivalent results if a person's tax rates stay constant.[5] So you can think of a Roth conversion more as a shift of assets from a taxable account (the conversion tax paid) to a tax-advantaged one. This explains why row 9 of Figure 1 shows no difference

(Fig. 1) Total After-Tax Value Of Assets To Heirs

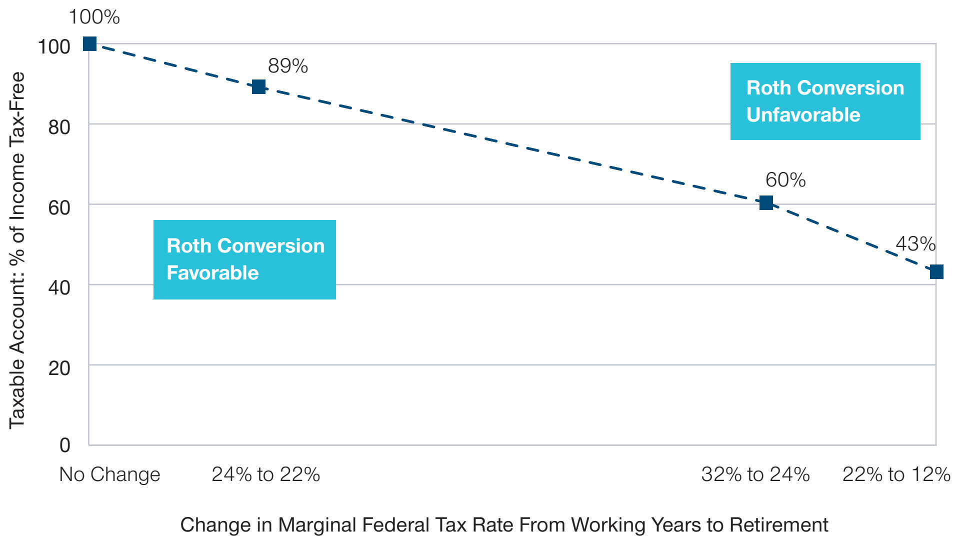
Value and Percent Difference From the Strategy Without Roth Conversions

	Ordinary Tax Rates vs. Working Years		No Conversion	Conversions Starting at Age 55		Conversions Starting at Age 65	
Tax Profile of Taxable Account	Retirement	Heir	Value	Value	% Diff	Value	% Diff
0% of returns tax-free; 50% subject to capital gains rate; 50% at ordinary rate	Unchanged	Unchanged	4,704,368	5,386,697	14.5%	4,858,254	3.3%
	Unchanged	Lower (22%)	4,723,659	5,391,665	14.1	4,874,075	3.2
	Lower (22%)	Unchanged	4,825,251	5,432,311	12.6	4,972,501	3.1
	Lower (22%)	Lower (22%)	4,844,542	5,437,279	12.2	4,988,322	3.0
50% of returns tax-free; 25% subject to capital gains rate; 25% at ordinary rate	Unchanged	Unchanged	5,151,668	5,515,797	7.1	5,233,070	1.6
	Unchanged	Lower (22%)	5,170,958	5,520,764	6.8	5,248,892	1.5
	Lower (22%)	Unchanged	5,262,118	5,561,703	5.7	5,341,375	1.5
	Lower (22%)	Lower (22%)	5,281,408	5,566,670	5.4	5,357,197	1.4
100% of returns tax-free; 0% subject to capital gains rate; 0% at ordinary rate	Unchanged	Unchanged	5,672,625	5,672,625	0.0	5,672,625	0.0
	Unchanged	Lower (22%)	5,691,915	5,677,592	-0.3	5,688,447	-0.1
	Lower (22%)	Unchanged	5,767,426	5,717,552	-0.9	5,770,895	0.1
	Lower (22%)	Lower (22%)	5,786,717	5,722,520	-1.1	5,786,717	0.0

[5] Kutner, George W.; Doney, Lloyd D.; Trebby, James P. Investment Performance Comparison Between Roth And Traditional Individual Retirement Accounts. Journal of Applied Business Research (JABR), [S.l.], v. 17, n. 1, Feb. 2001. ISSN 2157-8834. Available at: cluteinstitute.com/ojs/index.php/JABR/article/view/2064.

(Fig. 2) Roth Conversion Effectiveness

Breakeven Point Based on Tax Efficiency of Taxable Account and Amount of Tax Rate Decrease



between converting and not converting if tax rates stay constant and the taxable account is all tax-free.

It may also be surprising that the benefit of this shift from taxable to tax-advantaged can even outweigh a tax rate reduction in retirement. So we dug a little deeper to analyze the impact of taxable account profiles for different levels of tax rate reduction (see Figure 2).[6]

For example, if a couple's tax rate falls from 24% in working years to 22% in retirement, converting is favorable unless more than 89% of earnings in the taxable account are tax-free. For someone whose rate falls from 22% to 12%, converting becomes unfavorable when more than 43% of the taxable account earnings are tax-free. Again, these numbers rely on the specific situation evaluated, in which someone doesn't need RMDs for expenses in retirement, among other assumptions.

Conclusion

People approaching retirement age or recently retired should at least consider a Roth conversion strategy. Many of those people will correctly conclude that it's not practical or advantageous due to up-front taxes on the conversion.

However, our analysis paints a picture of people who could benefit significantly. These people have saved diligently in all of their pretax retirement accounts. They probably don't have significant Roth assets, because Roth contributions were unavailable or unattractive at their income level. They have taxable account assets, perhaps from windfalls or because they were able to save beyond retirement contribution limits. They may have a pension or other income sources that give them confidence they will leave assets to their heirs.

[6] This analysis assumes the taxable account generates only earnings at 0% or capital gains rates, not at ordinary rates. (This reflects a person who carefully manages assets across account types.) It also assumes the heirs' tax rate is the same as the person's tax rate during retirement. Starting amounts in the accounts, as well as the amount of annual conversions, are adjusted proportionally based on approximate income levels for the starting tax brackets. The analysis is based on starting conversions at age 55. Other assumptions are consistent with the analysis summarized in Figure 1.

For these investors, a Roth conversion reduces unwanted RMDs. It is especially attractive if their taxable income is low in their early retirement years. However, even if their tax rate stays flat or decreases in retirement, they may benefit from a Roth conversion if they are using a relatively tax-inefficient taxable account to pay the taxes on the conversion.

Because there are many interrelated factors in this decision, you may want to consult with a financial planner to evaluate your specific circumstances.

FINAL THOUGHTS

While it's difficult to "time the market," a Roth conversion is attractive when you believe your investments are particularly poised for growth (since you pay taxes on the value before it grows). You may also want to take advantage of low statutory tax rates before they're scheduled to rise.

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