Taxes in Retirement Series Part II

Jeff Clark, CFP®

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In Part II, Jeff Clark expands on the opportunity that Roth IRAs present retirees. He will discuss the benefits that proactive, long-term tax planning offer regardless of a person's situation.

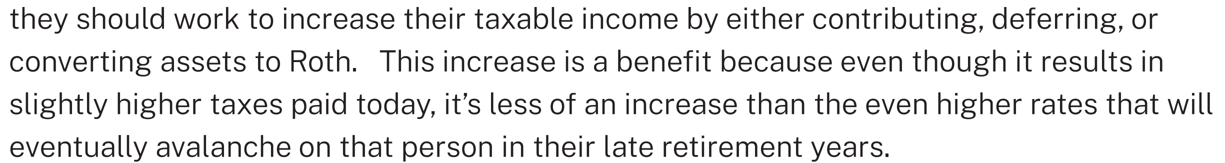
The Roth Opportunity

The primary difference between a Roth IRA and a Traditional IRA lies in comparing taxes paid today with taxes paid in the future. You might say that a Roth taxes the seed, while an IRA taxes the harvest. But what is the advantage of one over the other? If we lived in a flat tax world where taxes today and taxes in the future were the same, then there would be no advantage to either one over the other. In fact, the resulting amount of wealth, after taxes, would work out to be the same. However, if a person has reason to believe that their taxes in the future could be higher, then getting those dollars sheltered into Roth status is powerful because it locks in the lower tax rate today on those dollars and provides a shield against future taxes. What this means is that once a dollar achieves Roth status, that dollar will remain tax-free for a lifetime. (So long as the appropriate rules are followed.) And after that dollar gets into a Roth and gets invested, then the same tax benefit applies to the growth of the investments inside the Roth. They too can grow tax-deferred and ultimately be spent in the future tax-free.

So how can someone use the Roth to its best advantage? Fortunately, retirement planning software today allows us to project what a person's estimated tax trajectory will be over time. This projection of future taxes over time is important because it helps us answer the question of "How high could my taxes get?" Remember, the advantage of the Roth is based on comparing taxes today to taxes in the future, so it's important to get a bearing on how these will change over time.

This can be done by simulating what a person's *expenses* are, what their *income streams* will be, and *what level of tax* (at current rates) would be applied to those various streams each year to meet that need. Once this is done, we can define an "average effective tax rate" and see what their average tax rate over time is likely to be. If their taxes are pacing to get higher in the future than they are today, they might have a problem depending on how their wealth is currently structured.

With this foundation, a person can now be empowered with a decision framework to make educated choices on how to approach diversifying the tax status of their wealth between tax-deferred (IRA/401k), and tax-free (Roth/Roth 401k) accounts. In any year a person is on track to fall below their long-term average tax rate, (as compared to the projection)



they should work to increase their taxable income by either contributing, deferring, or converting assets to Roth. This increase is a benefit because even though it results in slightly higher taxes paid today, it's less of an increase than the even higher rates that will eventually avalanche on that person in their late retirement years.

Lastly, there should be a true sense of urgency in starting early because of the opportunity cost that will be paid by savers who are letting tax years go by where not enough money crosses the Roth finish line. Every dollar invested for retirement that is taxed below their most efficient tax rate is one day going to be taxed higher than it needs to be. It's almost impossible for this not to be the case. On a portfolio of $1,000,000, this ultimately could lead to hundreds of thousands of dollars in unnecessary taxes. It's much better to pay a little more in taxes today to avoid a lot more in taxes tomorrow.

Don't I Make Too Much To Use A Roth?

There are three main ways to achieve Roth tax status on your retirement savings and each comes with a different set of rules. Only one of those methods is limited by a person's level of taxable income. This means that in most circumstances, regardless of income, a person can get money into Roth status so long as they have either a current income from which to save or existing dollars in a qualified retirement account (Like an IRA or 401k) that can be converted to Roth.

The three ways to achieve Roth status are:

1. Contributions (typically from savings)

2. Deferrals (from your paycheck via payroll deductions in a company plan)

3. Conversions (from existing dollars already in a tax-deferred retirement account)

The first two options primarily apply to people who have not yet reached retirement although every option is available before retirement. However, if you are already retired and no longer earning a wage, feel free to skip ahead to option 3, the Roth Conversion. Of the Roth strategies available, Roth Conversion is the most impactful anyway.

Option 1 – Roth Contributions

Contributions to a Roth IRA are fully phased out for taxpayers with modified adjusted gross incomes over $140,000 (for single filers) and $208,000 for married filing jointly. If a person has an income low enough to qualify to max out this option, it's not the most effective as it only gets the job done for $6,000 /year per person ($7,000 if over the age of 50). Every bit helps, but of the three options, this approach has the lowest contribution limit available. For those who are looking to do more or have income over the phase-out limits, option 2, deferrals, is worth considering.

Option 2 – Roth 401(k) Deferrals

If a person has access to Roth 401(k) within their employer plan, they can contribute up to their maximum contribution limit as Roth 401(k) regardless of how high their salary is. (In most cases this would be a contribution limit of $30,000 for participants over the age of 50.) And many plans even offer a third after-tax contribution option within the company plan, allowing a person to make not only $30,000 in Roth 401(k) contributions, but to keep going by making after-tax non-deductible contributions towards the annual maximum of $73,500 between employee and employer contributions combined. These “after-tax” contributions, then, can be converted to Roth as well in a strategy known as “Mega Roth.” (More on this in a separate article) This leads us to option three.

Option 3 – Roth Conversions

Roth Conversions — moving money from a pre-tax account like an IRA or 401(k) directly to Roth — are available to everyone regardless of age if they have money in a tax-deferred account. Every dollar that is converted is then taxable as ordinary income, like a paycheck, based on the amount converted in that given tax year.

For example: Let’s say a couple who is retired is on pace to have $100,000 of taxable income for the tax year. Let us also assume that, after reviewing their retirement projections, they realize that their average tax will be closer to 15% federal during their retirement years. This creates a dilemma: Should they go on paying lower taxes now and hope for the best in the future?

If they do nothing, they’ll only pay about 10% in federal taxes when it’s across all their income this year, known as their effective tax rate. This is nice for this year, but eventually, they will be forced to pay more than 15% so anything they can do to shelter their existing wealth at a “tax cost” to them of less than 15% would be a savings in the long run.

Now let’s imagine that they recognize this and set a goal to fill up the 22% bracket. By doing this they will ultimately find themselves close to that 15% average tax rate across all their income while keeping their income low enough to avoid increasing their Medicare Part B premiums.

The Mechanics of a Roth Conversion

To do this and remain in the same tax bracket, this couple will need to lift their income to $190,750. Since they are on pace to fall short by $90,750, a Roth Conversion of $90,750 would be just enough to bring them up to that bracket without going over. The process is simple. If they have an IRA and a Roth at the same custodian, they can simply move that amount of assets from the IRA to the Roth. Since $90,750 is a big jump in income, it comes with quite the tax bill as well. They could pay the tax out of their savings, but many find it more

practical to simply withhold taxes (federal and state) from the conversion so there's no bill due at tax time next year. This also has the additional benefit of avoiding an underpayment penalty or the need to make estimated quarterly payments.

Repeated every year, this process could save them hundreds of thousands of dollars, depending on how much they have saved, how conservatively they live, and how high taxes ultimately get.

But What if Roth Rules Change?

In 2022 there was a strong opportunity for the Roth rules to be revisited when Congress addressed this issue as well as having a Democratic Party majority in the House, Senate, and Executive branch. The party most in favor of raising taxes had the opportunity, the majority, and the motivation to revisit these rules and surprised many by emboldening and protecting the rules around Roth's, effectively solidifying them for many election cycles to come.

In late 2022, what has come to be termed "SECURE Act 2.0" was passed as part of the Consolidated Appropriations Act of 2023. "SECURE 2.0" included a significant number of Roth-related changes (both involving Roth IRAs as well as Roth accounts in employer retirement plans), though notably, the legislation does not include any provisions that restrict or eliminate existing Roth strategies (e.g., backdoor Roth conversions).

These changes included eliminating RMDs for Roth's, adding a Roth option for SEP and SIMPLE IRAs, allowing employers to make their matching contributions as Roth, and allowing for transfers from 529 plans to Roth IRAs. One provision even requires both the savings as well as the matching within 401(k) for taxpayers with incomes over a certain level to be saved as Roth within the 401(k)!

Finding a Financial Advisor Who Can Actually Help with my Retirement Tax Strategy

When it comes to proactive tax planning for retirement, be certain that your financial advisor is equipped to help you with these exact scenarios.

Fortunately, Pine Grove Financial Group has fiduciary financial advisors on staff who can speak to your situation and give you specific and personalized advice on how to approach tax planning for your own retirement.

635 Bielenberg Drive | Suite 210
Woodbury, MN 55125 | **pinegrovefg.com**

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