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The Roth Conversion in Early Retirement

Roth IRAs are typically regarded as a savings strategy for working professionals. However, attributes of today's modern economy have created a window that invites newly retired professionals to execute Roth conversions early in their retirement years, when their income levels are otherwise very low. We'll explore this strategy and its likely beneficiaries. Some readers may be familiar with the notion of a "Roth Conversion Ladder". This article builds on the idea.

The Roth conversion option allows an individual to distribute pretax dollars set aside in a traditional IRA or 401k directly to a Roth IRA account. One can exercise this option *regardless of income level*. Taxes are paid on the ordinary income triggered by the distribution. Thereafter, the assets in the Roth IRA grow tax free.

In the past, newly retired professionals often began collecting social security at age 65, an age that coincided with their retirement. Many of these individuals also began collecting generous pensions from their lifetime employer. In effect, their income levels remained substantial throughout their retirement years.

Things have changed. Pension plans have been decimated in a trend that dovetails with the decline of unionized labor. According to the Bureau of Labor Statistics, less than 20% of today's workers participate in a defined benefit pension plan. For most, their primary savings vehicle is now a defined contribution plan such as a 401k.

Persistent low interest rates coupled with longer lifespans have made it optimal for many retirees to delay retirement benefits until age 70. It is therefore possible, if not likely, that professionals retiring today will have several years before the onset of ordinary income streams. Let's look at what might happen.

John and Sally retire today aged 65 after long professional careers. They will have accumulated both tax-deferred and taxable assets as well as substantial social security benefits. Their joint incomes will generally be too high for them to have made Roth IRA contributions during their working lives.

Here are some assumptions about Jack and Sally to get the ball rolling.

- *Taxable account of $500,000*
- *IRA and 401ks of $800,000 with Required Minimum Distributions of $30,000 starting at age 71*
- *No Roth IRA assets*
- *Each Spouse has accumulated Social Security Benefits of $32,000 annually at age 70*
- *Annual Retirement Spending requirements of $75,000*

Assuming average health, John and Sally are better off deferring social security benefits until age 70. (We'll ignore the spousal social security benefit). Moreover, they do not collect a private pension. Consequently, they are left to fund retirement spending with distributions from either their taxable account or their IRAs/401ks.

Financial planning 101 suggests that we delay distributions on tax-deferred accounts for as long as possible. Take advantage of their tax shield. If we follow this rule, retirement distributions should come from Jack and Sally's taxable account. What's interesting about this strategy is that it should leave the couple with a very low taxable income. The taxable assets may have a substantial cost basis themselves. Moreover, they can pick and choose assets to sell to minimize the taxable impact of their withdrawals. In today's investment climate, that could mean selling emerging market stocks and municipal bonds to generate minimal capital gains.

The illustration on the following page shows what taxable income could look like in early retirement. You'll note that most of the sales of assets from the couple's taxable account do NOT trigger taxes because the sold assets have a high cost basis. Graphically, most of the red bar is hollow - meaning that portion of the asset sale is tax free as return of capital. At age 70, both retirees begin collecting partially taxable social security benefits.

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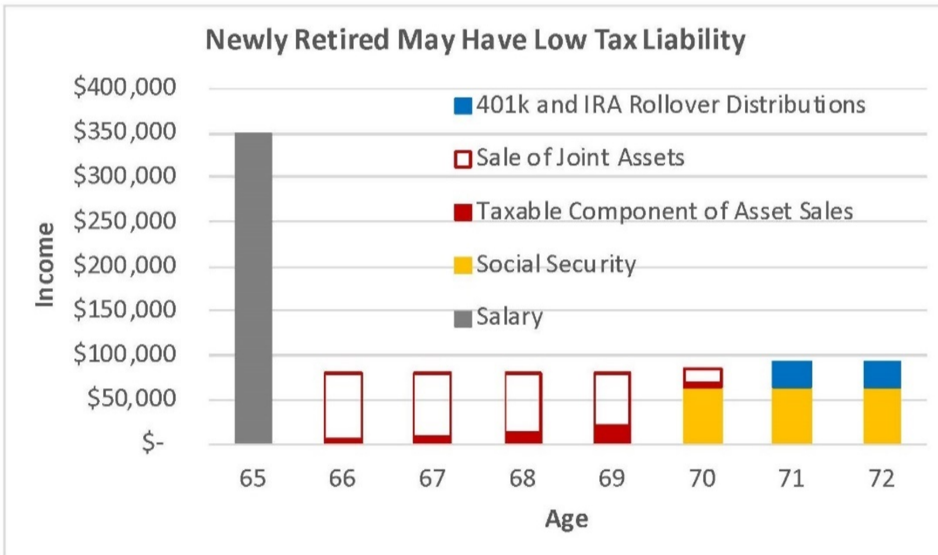
Special Notes of Interest:

The power generated in the US by wind turbines has doubled within the last five years.

Emerging Market stocks are up over 17% thus far in the calendar year

One year later, they begin taking required minimum distributions (RMDs) from their retirement accounts which are fully taxable as ordinary income.



The economic value of a Roth IRA is even greater than the mathematical value of its tax shield. It gives its owner options. What if John and Sally have an unexpected expense like a new roof? Without a Roth IRA, they might otherwise tap into taxable 401k resources to pay for the repair. That could put them in an unanticipated higher tax bracket. The Roth IRA would allow them to handle unexpected distribution needs without affecting their tax liability.

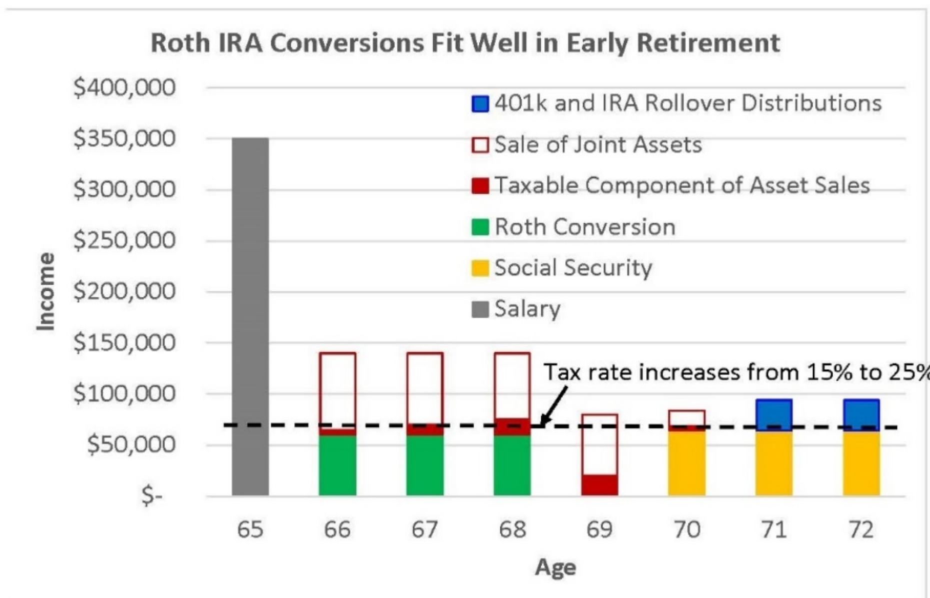
The window for executing a Roth Conversion is just a few years. The graph at the bottom of the page illustrates how it looks year by year. While these are rough estimates of taxable income, it's easy to surmise that some level of substantial Roth conversions can be undertaken for many retiring professionals.

The dearth of taxable income in early retirement suggests that a Roth conversion strategy during those years can add substantial value. A married couple filing jointly pays tax at a 15% rate on income up to $76,000. That rate increases to 25% at income levels from $76,000 to $152,000. Why not pay some taxes in early retirement, while the couple's tax burden is relatively low.

The Roth conversion strategy not only allows the John and Sally to pay a lower tax rate on distributions from retirement accounts, it allows these distributions to grow tax free in a Roth IRA account.

Of course, not every couple fits the model described above. Many couples already have substantial Roth IRA assets from a prior conversion or a Roth 401k option provided by their employer. Their taxable account may consist solely of highly appreciated stock. These folks might look to recognize their substantial capital gains in early retirement while the applicable rate is 0%.

For married couples filing jointly, a 0% capital gains tax applies for income up to $76,000. If a family is neither taking RMDs nor collecting social security benefits, they are in a position to sell lots of appreciated stock without paying any capital gains tax. There is no reason why they could execute Roth conversions AND recognize long term capital gains during the few years where ordinary income streams dry up.



It's important to remember that a Roth conversion or capital gains strategy are models for action, not specific recommendations. Real spouses have different ages, health issues, account balances, etc. The key concept that I am try to convey is that the early retirement years typically witness a substantial drop in taxable income. That creates an opportunity to recognize income at advantageous rates.