Episode #265: Potential for 3 Discounts on Strategic Roth IRA Conversions

Hi. Welcome to another episode of "Money Script Monday." My name is Brian Manderscheid. Today I want to talk about the potential for three discounts on strategic Roth IRA conversions. Now this is a topic we're very passionate about, and it's a great time to be having this conversation as a lot of our clients are meeting with their advisors, with their tax professionals on year-end tax planning strategies to hopefully reduce their future tax obligations. Roth IRA conversions are basically a way to convert retirement accounts into a tax-free account, which is a Roth, enjoy tax-free income, tax-free growth, no RMD requirements, tax-free legacy to kids or grandkids.

This is a really great concept to talk about. In addition to that, it's also a great time in the market because there are three potential discounts that we're going to talk about today: tax rate discount, market value discount, and lastly, the tax base discount. First, let's talk about the tax rate discount. Now we have a unique situation in that we know that tax rates are increasing in 2026 when the Tax Cuts and Jobs Act sunsets. You see, we're all going to go to bed December 31st, 2025 on New Year's Eve, wake up the next morning on New Year's Day, January 1st, 2026, majority of us are going to owe more taxes purely because we're going to hit this fiscal cliff, and this tax law, Tax Cuts and Jobs Act, is sunsetting that year.

What this basically means is higher tax rates for a majority of people, it also means a lower standard deduction, other random tax items are changing, cap gains, capital gains, AMT, alternative minimum tax, and even the child tax credit is being reduced. Essentially, if you look at what the current tax rates are for the next 4 tax years versus what they're going to be in 2026, the 10% bracket, again, remains unchanged. But you can see the federal marginal tax bracket's going from 12 to 15, 22 to 25, and so on and so forth. Essentially, by converting over the next four tax years, you're getting a discounted rate versus if you waited four tax years to do those same conversions.

Additionally, we have something going on right now, which is rampant inflation. And what is inflation doing to these tax brackets is, in 2023, they're all being bumped up on a dollar basis. So for example, the 24% tax bracket is going up by about $24,000, essentially allowing you to convert more and still stay in the same low tax bracket. So that's the tax rate discount, again, over the next four tax years. Let's move on to market value discount. Now, unfortunately, this year has not been the greatest for both stock and bond returns, and our account balances, unfortunately, have suffered.

For example, if we look at the S&P 500, it's down about 24% as of the end of Q3 2022. Not just the equity markets, but the U.S. Aggregate Bond Index was also down double digits, almost 15% over that same timeframe. Now, again, we never like losing money, but we can actually use this pullback in the stock market and bond market as a potential opportunity. Let's say, our balance of our IRA was at $500,000 at the beginning of the year, and we lost 20%, let's just say now it's at 400,000, what that means is we can basically convert a lower value and therefore pay lower taxes. In addition, once the stock market eventually rebounds, which historically it does, all those future gains will be tax-free.

Versus if we waited until the market does potentially rebound, we're going to be paying taxes on a higher amount. Now, the problem is that we typically don't convert an entire account balance in one tax year as it pushes us into higher marginal rates. I'll talk about the third strategy, which will help eliminate or reduce that potential increase. We talk about tax rate discount, the market value discount. Let's talk about the third discount, which is the tax base discount.

Again, I mentioned that the potential downfall or potential obstacle with doing strategic Roth IRA conversions, again, we don't typically convert an entire balance in one year, bumps us up into a higher tax bracket. We convert over a period of time, typically the next four tax years, because, again, they're discounted. The problem is, what happens if the market rebounds over those next four years? We'd actually have to be paying taxes on higher balances each year.

However, what we can do is lock in today's tax base using a five-year point-to-point index. With this strategy, our account value essentially doesn't grow until the end of the fifth year, and that is when we receive all of our returns. Normally, that may not be the best strategy, but this works out perfectly for strategic Roth IRA conversions, because, again, it allows us to lock in today's tax base, convert over a period of time without having any growth. Once we convert all of our IRA at the end of the fifth year, all those gains would be tax-free.

Let's just say hypothetically we have a $400,000 account balance growing at 10%. So, if the market rebounds and we don't use this discount, we convert $100,000 today, 2022, the next year, 2023, our account value's higher. So, we have to convert 110,000, then 121,000 in 2024, and lastly, in 2025, 133,000, basically converting a total of 464,000 over the next 4 tax years. Our ending balance, Roth balance, at that point in time is 585,000. You can see if the market rebounds, we'll pay more in taxes by converting over a period of time. However, if we use our 5-year index, which doesn't grow until the end of the fifth year, you can see we're converting 100,000 each of these next 4 tax years with a total amount converted 400,000.

If you're in a 30% tax bracket, hypothetically, you're saving about $20,000 in taxes using the strategy. After the index returns at the end of the fifth year, all those gains will be tax-free. To sum up and wrap things up for today, we talked about the three potential discounts for Roth IRA conversions, the tax rate discount, market value discount, and lastly, the tax base discount. This is something that we're really passionate about because there's a 31 trillion national debt and growing, because of all the COVID relief packages and additional spending packages that have been passed over the last few years.

Additionally, we have higher interest rates as well, meaning that just the interest on the debt alone is 965 million per day. This is a huge issue, and the reality is, this issue is likely to affect the people who pay majority of taxes, those higher income earning families. We just saw recently in the UK, they're dealing with their own crisis, debt crisis there. They announced today that they're going to raise taxes on the wealthy overseas. We know that tax rates for sure, at least as law stands today in 2026, if this debt situation isn't figured out, the tax rates could potentially go up even more than that. A strong opportunity to take all these discounts into your favor, and provide tax-free benefits for your future. If you have any questions about the content, Roth IRA conversions, please contact the advisor who sent you this video. Thank you very much. We'll see you next time.