Episode #327 - Roth IRA Conversion Tax Traps

Hi, welcome to another episode of Money Script Monday. My name is Brian Manderscheid and today I want to discuss Roth IRA conversion tax traps. Roth IRAs may make a lot of sense for people who believe they'll be at a higher tax rate in the future and generally have the ability to pay the taxes out of cash or cash flow. There are a lot of advisors out there who are recommending Roth IRA conversions, and the question they generally ask is, "Do you believe tax rates will be higher or lower in the future?" I think a lot of us when asked that question think tax rates are most likely going to be higher in the future, but we don't believe that's the right question to be asking. Instead, we believe the right question to ask and think about is, "Do you believe that you will be in a higher tax rate in the future?

For today's video, what we want to discuss are future tax rates, and the factors that will determine those, and also some tax thresholds to keep in mind so that you can successfully do Roth IRA conversions strategically over time while avoiding some of these tax traps.

First, let's talk about future tax rates. Now your tax rate is all going to be based on your taxable income. You have to think to yourself, "Is my future taxable income going to be the same or higher than it is today?" For some people, that may not be the case. For example, let's say you're in the peak income earning years of your life, making really, really good money, and when you retire, you're simply going to be living off a lot less and therefore have potentially a lower tax income and potentially a lower tax rate. In that case, it may not make sense for you to do the Roth conversions, at least now, and instead potentially wait until you're retired.

Another thing to consider is your required minimum distributions or your RMDs. They are based on your age, you may be taking your RMDs now which you cannot convert the amount that you have to take for RMDs, you can convert over and above that, or you may have to take RMDs in the future whether that's age 73 or age 75. If you think about it if

your taxable income is at a certain level and all of a sudden when you reach that RMD age, you now are forced to take out these taxable distributions, those potentially may bump up your taxable income and thus your tax rate.

Your residence state is also something to consider. You may be currently working and living in a high state tax rate like California or New York, for example, with plans to potentially relocate and retire in a state that has no or lower state tax rate, for example, Florida or maybe even Texas. If you are living in a state that has a high tax rate, it may not make sense to do those conversions now, but instead, potentially down the road when you are in another state that has no or lower tax rate.

The widow tax is also something to be considered. The widow tax has to do with the fact that the marginal tax rates are structured differently for married filing jointly and a single filer. For example, if your surviving spouse is going to live off roughly the same taxable income, they may be forced into a higher tax bracket purely because of the tax rate structure between married filing jointly and single. If there's a potentially a large age gap or maybe a large health gap, it may make sense to do the conversions now while you're still married versus doing them down the road when potentially your spouse will be in a higher tax bracket.

Parents versus kids is also something to consider. If you're in your older ages, the benefits of a Roth IRA conversion may be more heavily weighted to your beneficiaries, for your kids for this instance. Let's say hypothetically, you're at the very, very top tax bracket and your kids currently and foreseeably in the future will be in a much lower tax rate. It may potentially not make sense for you to pay the taxes at your very top tax rate and have the kids receive the money tax-free. Instead, it may make sense to not do the conversions at your current high tax rates and have the kids pay the taxes over 10 years when they inherit the money.

I think the last thing is sort of a wild card. We know what the tax law tax rates are today and what the tax law changes are going to be, but there's a huge national debt issue. We don't know in 10, 15, 20 years what the government will need at that point in time, and therefore, what may happen to future tax rates. What we know today is in 2026, the Tax Cuts and Jobs Act is set to sunset, meaning that your current tax rate is most likely going to be higher in two short tax years, and you'll potentially also have a lower standard deduction. Some clients are trying to get ahead of this fiscal cliff and convert at today's lower tax rates, knowing that as the law stands today, they're going to go up in 2026 and depending upon what may happen in the future, could even go up from there. Those are a few issues to think about in regard to your future tax rates versus your current tax rate. Let's next talk about some various tax thresholds to consider.

I think the most common one that most people think about is their federal marginal tax rate. This is going to differ from person to person but to give you an example, let's say your taxable income is $200,000. You're married filing jointly and this is all for 2024. You're currently in the 22% marginal tax bracket. Everything over and above the $201,000 and change is pushed into a higher tax bracket at 24%. For example, let's say your taxable income is $200,000, you convert $50,000 to Roth, a very small portion of that be taxed at your 22% bracket, and the rest will be bumped up into your 24% bracket. That may not be potentially a bad thing considering the 22% bracket is scheduled to go up to 25% in 2026, and the 24% bracket is scheduled to go up to 28%.

Nonetheless, it's worth looking at where you fall in the current your current bracket. You may want to convert only up to the bracket. For example, if you're only in the 12, it may not make sense to jump up to 24 and it may make sense to do conversions over time instead of doing the conversion all at once and umping yourself into potentially a higher tax bracket.

State tax rates. You may be living in a state that has no tax state tax, some states have flat taxes, and others have a marginal system. It's important to look at what your state tax rates are and bring that into the equation.

If you're age 65 and currently receiving Medicare, your Medicare premiums are based on your modified adjusted gross income. If you do Roth IRA conversions and go over and above some of these limits, you can actually be paying higher premiums on your Medicare, which is an additional cost to consider, and potentially you may want to stay below some of these limits. In this case, $206,000 for a couple, married filing jointly, for the modified adjusted gross income to avoid jumping into a higher bracket and paying higher Medicare premiums.

If you're currently receiving Social Security, your Social Security income is either not taxed at all or taxed at 50%. But if you have a modified adjusted gross income of $44,000 and up for married filing jointly, 85% of your Social Security is taxable and this is all based on your income. If you're in a very low taxable income base, it may or may not make sense to do the conversion, or at least do them do smaller amounts to stay within those thresholds to avoid paying higher taxes on your Social Security benefits. If you are married and filing jointly for 2024 and in excess of $250,000 of taxable income, you're going to have to pay an additional two 3.8% on your net investment income for this Medicare surtax. Again, another threshold tax trap to think about.

Lastly, capital gains. Long-term capital gains are either taxed at 0%, 15%, or 20%. The 20% level is fairly high at over $583,000 married filing jointly. If you drastically increase your taxable income with Roth IRA conversions, in a single tax year, you may also invertedly cause higher capital gains on your long-term capital gains.

Those are some various tax thresholds to keep in mind and tax traps to consider. We also talked about ways to think about your current tax rate

and your taxable income versus what it may look like in the
future. What I'll say is that Roth conversions may make sense if you believe you will be in a higher tax rate in the future and have the ability to pay the taxes generally out of cash or cash flow. If you have any questions about what your situation looks like and if you should do Roth IRA conversions or how to structure them, whether all upfront or strategically over time, please contact the advisor who sent you this video and work with a licensed tax professional to help give you tax advice on your individual situation. With that, thank you very much and we'll see you next time.