Episode #330 - Paying Roth Conversion Taxes without Burning a Hole in Your Pocket

Hey there. My name is Kevin Nuber. Thank you so much for watching today's episode of Money Script Monday, where I'm going to be talking about how to pay the Roth conversion taxes without having to burn a hole in your pocket. The goal of this video is to show you how to do that Roth conversion and pay the taxes without having to sacrifice all of your other savings and retirement accounts in order to do so.

Every week we're working on cases and hearing from clients over and over again saying that they're extremely concerned about all this money that they're accumulating in their tax-deferred accounts like their 401K's and the IRA's. This has been happening far more today than in years past, and I was thinking about it. Why is this happening? I think there's two things that are really happening.

First is, on one side, it seems like the federal government every single year releases a new federal spending proposal or budget plan, that inevitably increases the size and scope of the federal government and the amount of money that they're spending. In order to do that, they have to keep borrowing and borrowing and borrowing and at this point, we're seeing the national debt growing to a number that's completely unfathomable. It just doesn't even make sense to any of us. It's not just my humble opinion, it's pretty much everybody's opinion out there who are way more smart than I am in this field. This is a completely unsustainable path.

The second thing that's happening is you as a consumer, you're sitting there saving all of your money into these retirement accounts that haven't been taxed yet. They're tax deferred. You're postponing the taxation on these accounts to some future unknown point. At that future point, the tax rate is going to be determined then.

You're seeing these two things happen concurrently. The national debt is going up through the roof. You're saving all this money into these tax postponed accounts or tax-deferred accounts, and all of a sudden, you're thinking, what can I do to get out of this tax-deferred account and go somewhere completely tax-free?

What I'm going to be talking about today is how do you do this in a way where you don't have to sacrifice all of your other savings' accounts, your cash accounts, all these other things in order to pay the taxes on your on that money? How can you do it in an efficient way so that you're not shooting yourself in the foot while you're going tax-free.

Here's how the idea works. The goal is we're going to start with $500,000 in an IRA or 401K. At the end of this time period in which we do these series of structured conversions, where we convert the money to over to a Roth IRA, I want to have at least $500,000 in the Roth IRA by the time that we're done. Now, this is going to be tough because you have to pay taxes on that money. How are we going to do this?

In this account, we're going to put $500,000. Now this financial institution is going to give a bonus on that money, and they're going to give you an extra $65,000 starting day one, so you start out with $565,000. Now, bonuses can be as high as 20 and they can be as low as 0. I'm assuming 13% for this particular example.

We're also going to assume that when you do the conversion, you're going to be in a 24% tax bracket. Your tax bracket could be higher, it could be lower. That's not the point. We're just going to use 24% because this is a reasonable tax rate to assume when someone does a conversion.

Each year for five years, we're going to convert the exact same amount and we're going to convert $127,000 each year. Now when you do this, you'll have to pay taxes on that IRA as you're going to that tax-free account. You're in a 24% tax bracket. That means that you're going to have to pay a little bit over $30,000 a year in taxes, in order to convert.

Each year, we're going to assume that you earn 4%. This is not a guaranteed interest rate. This is just a reasonable assumption for what this account is going to earn over this period of time. It could be much more. It could be a little bit less, but 4% is a reasonable rate.

Here's how this works. Here's the $500,000 line. This is our goal and what we want to do is we want to go year by year and we want to make sure that the sum total of all these accounts is still more than $500,000. That's represented here by this orange bar. You can see we always want to stay above this $500,000 line. How does this work? Here's what we do.

The very first year you're going to convert $127,000. You're going to pay $30,000 in taxes and you're going to earn a 4% rate of return. We're going to have a Roth IRA account, this is your tax-free bucket, now has $96,520 in this account. The sum total of all of your accounts, including your IRA is $557,000, so it's above that $500,000 line. So far, so good. First year mission accomplished. We have more than $500,000 after doing the first-year broad conversion.

We go to year two and we do the same $127,000 conversion. It adds to the Roth account you pay, the taxes you run a rate of return. Now the sum total of all of your accounts is $548,000. Once again, you're above that $500,000 line. Everything's good. Notice that your year-to-year actual total account balance goes down. This is fine because remember, you're paying $30,000 in taxes every single year as you're doing this Roth conversion. Our goal is in the end, we want to have more than $500,000.

In year three now we have $301,000 for a total of $540,000. If we fast forward to year five, we've now converted the entire Roth IRA balance. Now you have $522,000 in your Roth IRA, which is now the sum total of all of your accounts, and you can see that we're still above that $500,000.

What we've done here is we've done a strategic Roth conversion over a five-year period. We did this to keep your tax rate as low as possible. We used an account that has a bonus in the first year. After it earns a reasonable rate of return, you end up with $522,000 after five years, which is more than you started with.

If you're out there and you're sitting on an account balance and a tax-deferred account IRA or 401K and you're concerned about the taxes on that account at some point in the future and you are looking for a way to put that money that's somewhere completely tax-free but you're concerned that you want to be able to do this in an efficient way to make sure that you're not sacrificing all of your other retirement accounts to do that, then this is a fantastic strategy for you to use and you can convert all of your 401K over or IRA over a period of time. Pay those Roth conversion taxes and not have to burn that hole in your pocket. Thank you for watching.