

## TO ROTH OR NOT TO ROTH, THAT IS THE QUESTION

By David B. Loeper, CIMA<sup>®</sup>, CIMC<sup>®</sup>

*“The wages of sin are death. But by the time taxes are taken out, it’s just sort of a tired feeling.”*  
- Paula Poundstone

More and more Roth conversion calculators are showing up every day with the new Roth conversion rules being lifted for high earners starting next year with a “one time special offer” to spread the tax bite of conversion out over two years. If you use one of these calculators, don’t say I didn’t warn you about how misleading the results might be of such analysis. Like any program the output is only as good as the input, and some of those inputs are **the assumptions** the program uses in the analysis. These assumptions about the future (which is of course uncertain) can wildly skew the answer to make the Roth look artificially attractive.

### Misleading Roth Analysis

An Advisory Board member of our firm recently shared a paper with me about Roth conversions written by a large, respectable investment firm. The paper summarized key criterion of what would generally be the circumstances where a Roth conversion, or use of the Roth, would make sense.

Paraphrasing the paper, the “best candidates for conversion” are those who have taxable assets to pay for the conversion, and ANY ONE of the following conditions are present:

- 1) Tax rates in retirement are unlikely to be materially lower than pre-retirement rates.
- 2) Conversion is taking place at a young age.
- 3) There will not be a material income need from the IRA, withdrawals from the IRA will be needed only much later in life, or the IRA assets are used to fund an estate goal (no need for withdrawals at all).

The article proceeded to calculate all sorts of advantages for Roth conversions with only small, incremental benefits in certain rare circumstances of avoiding the certainty of taxes now by not converting. Much of the supposed cause for the Roth advantage is based on required minimum distributions (RMDs) which of course our engine automatically calculates and taxes dynamically for each year of each simulation.

I have to disclose to you that I am personally highly skeptical of the promises of the Roth for a few reasons. First, I fear that future governments will change their mind on the Roth’s tax exempt status. Understand that Roth conversions (or contributions) increase current tax revenues at the expense of future revenues. In essence the government is mortgaging future tax revenues to collect them now. Roll forward thirty years and imagine the justification Congress might argue for in

  
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applying a surtax on all of these Roth multi-millionaires who don't pay any taxes at all. It seems it would be rather tempting for Congress to make a "needs based amendment" to the tax exempt status. It is certainly conceivable this could occur, and while I wouldn't plan for it, I also would not assume there is no risk of it occurring either... especially for those using Roth to accumulate significant estate assets.

Secondly, the new Roth conversion rules are *an option* for anyone to execute at some date in the future, and with a highly uncertain future, basic option theory and common sense should tell us that we should not pay additional tax now with certainty if we can avoid it, unless there is a *clearly compelling advantage* to do so. In the future, this new Roth conversion option for high earners may be repealed, but I would not rush to pay a huge tax bite now if I can defer executing that option until some later date when some of the uncertainties of time have passed or a repeal of the option is imminent.

Finally, when analyzed properly, the Roth advantage is actually a detriment in many cases where it is normally assumed to be advantageous, if one applies Wealthcare and is concerned about confidence of funding prioritized life goals and avoiding needless lifestyle sacrifice.

Let's take a look at dispelling the erroneous assumptions that a Roth is advantageous for the young, when retirement tax rates are going to be as high or higher as tax rates during earning years and when withdrawals won't happen for many years into the future. A scenario examining all three of these Roth favorable conditions is simple to model.

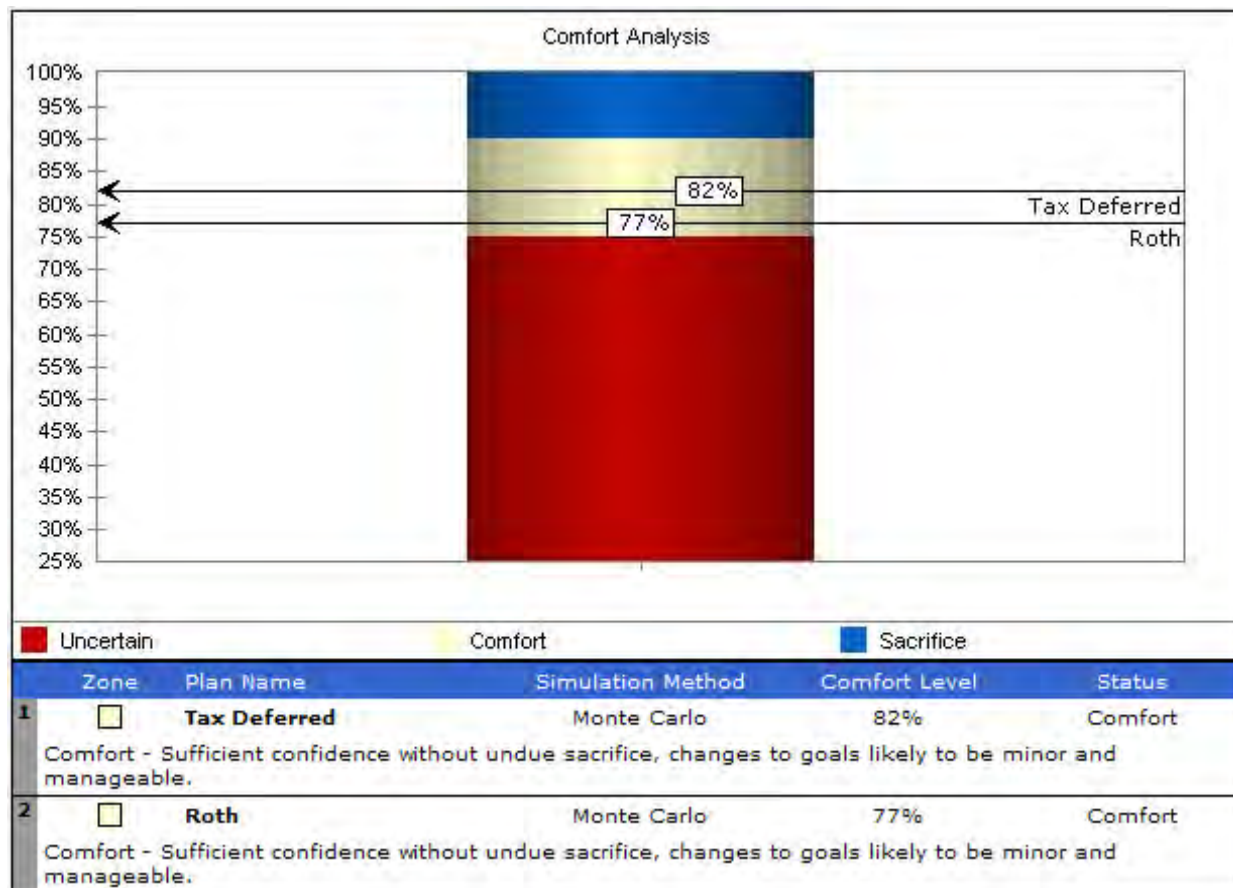
For example, take a single 30 year old that earns \$85,000 a year in moderately taxed Virginia. His combined federal and state marginal rate is 30.75%. He has nothing saved but knows he should start saving for retirement and is considering whether he should contribute to the Roth 401(k) his company offers, or just a traditional 401(k) with a pre-tax contribution. He plans on retiring at age 65 on an after tax spending budget of \$60,000 a year adjusted for inflation, and he has no estate goals. The taxes on his retirement income will be at the same rate or higher if he funds the traditional 401(k) (depending on RMDs in each year of each simulation which we automatically calculate and tax). Trusting the promise of future Roth exempt status, he likewise trusts that Social Security will pay him his projected \$23,464 annual benefit at retirement. To start saving for retirement, he determines that his lifestyle could afford a compromise to his current spending of \$5,886 a year. This is what he could save after tax in the Roth 401(k). In the traditional 401(k), that same lifestyle compromise would make the pre-tax contribution \$8,500 a year because he would avoid paying current income taxes of \$2,614 on his salary deferral. Both plans assume a balanced asset allocation due to his tolerance for risk and living to age 92, his 80<sup>th</sup> percentile life expectancy.

This example should be a poster child for the attractiveness of Roth. We have a young person deferring distributions for many years and taxes in retirement that are as high or higher than his current moderate tax rate. The Roth should show a no-brainer advantage, correct?

Well, *Exhibit 1* demonstrates that the confidence level of exceeding his goals is HIGHER with the traditional 401(k) deferral than with the Roth. How could this be when so many other systems would show the Roth as the no-brainer choice for such a situation? There are many causes for this including the more realistic dynamic taxation of RMDs in our system, where we are measuring

confidence (in the comfort zone as opposed to the median result), and our recognition of the price to the lifestyle of the client.

*Exhibit 1- 30 Year old Roth versus Traditional Tax Deferred 401(k)*



	Tax Deferred	Roth
<b>Retirement Age</b>		
Young	65	65
<b>Retirement Need</b>		
Young	\$60,000	\$60,000
<b>Target End Value</b>		
Today's Dollars	\$1	\$1
Actual Dollars	\$6	\$6
<b>Avg. Annual Savings</b>		
Young	\$8,500	\$5,886
<b>Default Inflation Rate</b>	3%	3%
<b>Investment Adjustment</b>	0.00%	0.00%
<b>Median Return</b>	9.59%	9.59%
<b>Risk</b>		
Std. Deviation**	11.54%	11.54%
Downside (95%-tile)**	-7.76%	-7.76%

Defenders of needlessly prepaying taxes will say it is erroneous to conclude that this client would leave nothing behind in the estate and part of the benefit of Roth is how the assets transfer to heirs by avoiding income taxation on accumulated tax deferred IRA assets. Of course, if he wanted to leave an estate we would have identified and prioritized this goal and if he didn't want to leave an estate the Wealthcare process allows us to confidently manage his plan to have his money and blood pressure run out near the same time. But, assuming he has an estate goal, to model this we will bump up his savings to an \$8,500 Roth contribution, a lifestyle equivalent \$12,274 tax deferred contribution and add a goal of a \$1 million estate in today's dollars (\$6.4 million in actual dollars). This gives the Roth 78% confidence of exceeding his income and estate goals after income taxes (but before estate taxes).

The traditional 401(k) would have 86% confidence of exceeding the \$1,000,000 estate goal, but this is before income taxes on the amount remaining in tax deferred assets. For the traditional 401(k), the 78<sup>th</sup> %-tile outcome leaves his estate with \$615,489 in taxable assets<sup>1</sup> with a stepped up basis and \$850,878 in tax deferred assets that would be subject to ordinary income tax. If we assume the beneficiaries immediately pay the income tax bill on this, their tax rate would have to be about 55% on the tax deferred assets to be at a disadvantage to the Roth. Tax rates could go this high. It is unknown and if they did, the Roth conversion would look attractive. Of course, most people would apply some common sense and would opt to stretch out the tax bite if possible as is often the case.

Within the distribution of outcomes, there are advantages to Roth for this combined income and estate goal circumstance. For example, at the 50<sup>th</sup> %-tile outcome, the Roth would leave an estate that is 2.8 times his estate goal (assuming of course the client wouldn't use the couple extra million dollars for his lifestyle). The tax deferred account would leave an estate that is 3.3 times his estate goal but with a significant amount in tax deferred balances with income taxes still due. At the 50<sup>th</sup> %-tile, the breakeven tax rate on the tax deferred assets left for the heirs would be only 23% to equal the wealth of the tax exempt Roth. Of course we have no idea what the tax rate will be for heirs or how long they would stretch out the distributions. We also don't know whether the client would end up spending more than we are assuming if he had a couple extra million dollars lying around, completely changing the analysis.

What we do know is that as confidence increases (lower investment return scenarios) the deferring of taxation in the traditional 401(k) or IRA makes it reasonably unlikely the future tax bite heirs will pay will be high enough to justify the Roth conversion (i.e. 55% tax rate at the 78<sup>th</sup> %-tile). We also know that if returns are higher and goals are thus being significantly exceeded, there is a greater and greater likelihood that the Roth tax treatment would have a wealth advantage over tax deferred treatment, albeit at levels of goals that are already at multiples of the client's goals (for example, at the 50<sup>th</sup> %-tile heirs' income taxes at more than 23% would show an advantage to the Roth but the estate would already be 2.8 times more than desired).

This should dispel some of the normal assumptions made about the advantages of Roth. It just isn't as easy as assuming a flat tax rate on all scenarios as the taxes will in reality vary from year to year based on uncertain market behavior. The higher returns are, the more likely there will be a wealth

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<sup>1</sup> Taxable assets were accumulated by forced RMDs above his income need that were taxed at ordinary income tax rates and then invested in a taxable account with 20% turnover and 20% short term capital gains rates, about twice what we would safely assume with our portfolio management approach.

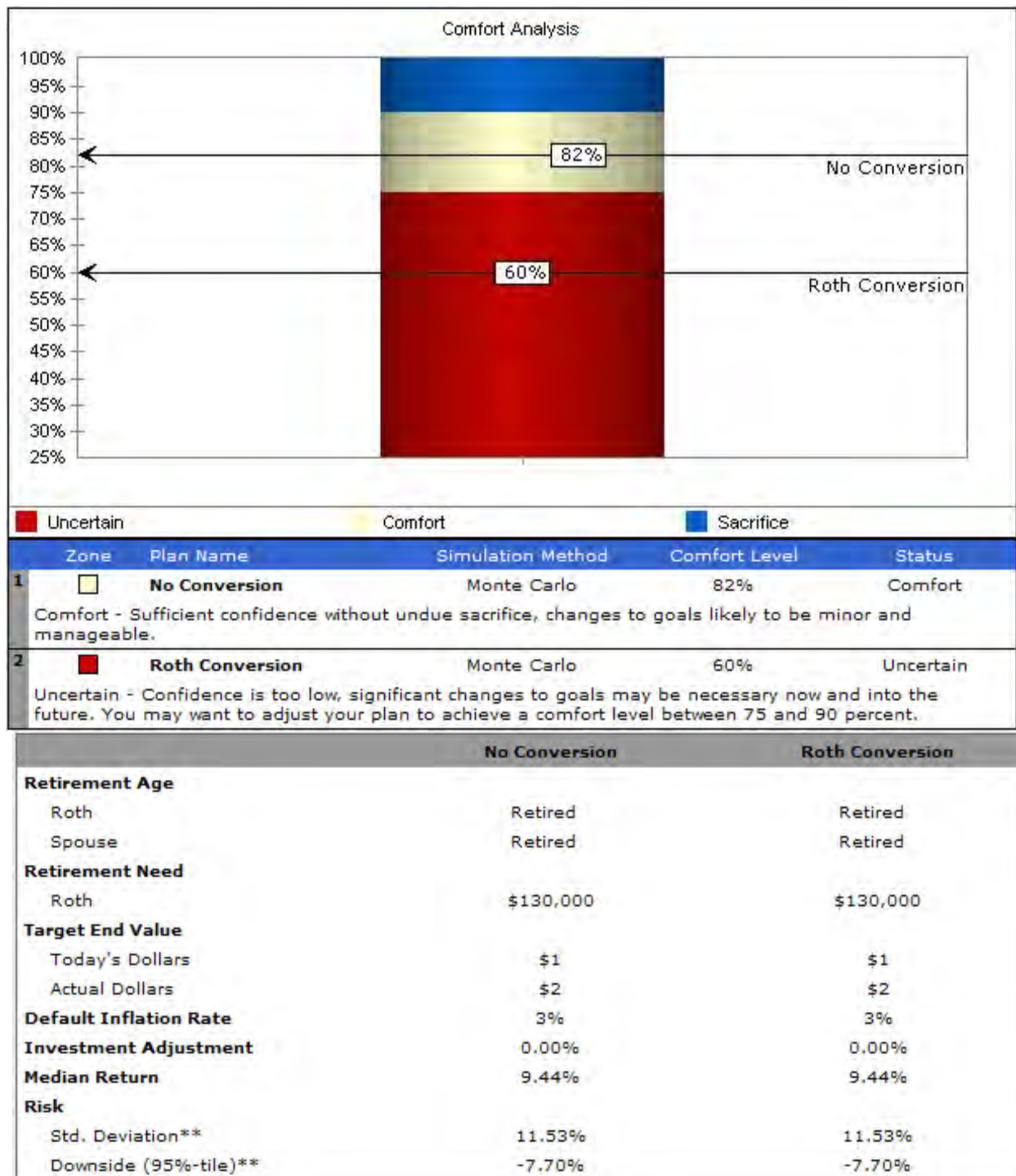
advantage to the Roth but also less confidence one can have in achieving those higher returns. The paper showed another example that is perhaps more germane to the decision many high earners are now faced with, that is, whether they should convert now after already having accumulated significant tax deferred assets.

The paper showed several examples that claimed a high probability of an advantage for Roth if one had taxable assets to pay for the conversion. In fact, the paper claimed a 97% probability for an advantage to Roth if tax rates didn't decline in retirement for someone that had \$1 million in tax deferred assets and \$450,000 in taxable assets that are used to pay for the Roth conversion. Silly assumptions in the calculations caused this ridiculous conclusion.

Replicating the analysis in our system, I take the same 65 year old couple that is faced with making this decision today, the same 20 year time horizon (they used normal life expectancy) the same present account values and even the same 60/40 asset allocation assumption. Instead of assuming the same flat tax rate regardless of what goes on in the market simulations, I use our dynamic tax assumptions that calculate the differing year by year tax rates, forced RMDs, deferring tax deferred withdrawals until RMDs kick in or there is a need to do so to meet spending goals, etc. This is more akin to how we would actually manage our client's affairs. To keep their tax rates on the IRA distributions high, I included a taxable retirement pension income of \$60,000 starting at age 65 and assumed an after tax inflation adjusted spending need of \$130,000. (Keep in mind in our process we are concerned with the lifestyle of what our clients can actually spend, so our engine forces larger distributions and taxes them sufficiently to meet the net spending desired.) This assumption about income is what is materially different from the erroneous analysis of the paper our board member provided.

The way the paper approached income distribution was to simply take 1/20<sup>th</sup> of the Roth value the first year, 1/19 the next and so on until it was depleted and then distributed the same dollar amounts from the IRA and taxed any remaining assets all at once at ordinary income rates at the end. Never mind that no one would do this and couldn't really plan on a retirement lifestyle with this spending approach. But, by doing the analysis this way, along with fixed tax assumptions despite uncertain market returns leads us to the erroneous conclusion there is a 97% chance we should rush to stroke a \$450,000 check to the IRS. Hopefully 100% of the public is smarter than this and has a Wealthcare advisor that has the skill to appropriately model their unique situation. *Exhibit 2* demonstrates that there is a cost to needlessly writing that check to the IRS.

Exhibit 2, confidence levels of supporting a \$130,000 spending need for 20 Years by converting a \$1 million IRA to a Roth, versus keeping IRA and \$450,000 of taxable assets with \$60,000 pension:



Please do not take this analysis as an assumption that the Roth option is uniformly unattractive. There are a number of circumstances where one would benefit from the Roth conversion. The key thing to remember is that paying taxes now with certainty has an uncertain future benefit *or cost*.

The odds of a conversion being beneficial are reasonably high. Yet at comfortable confidence levels, the certainty of giving up that asset and the flexibility of choice that having that asset offers can come at a price. Even if one is only making modest distributions and using these assets to grow an estate, at comfort zone confidence levels it is often advantageous to avoid conversion. If markets perform better than these levels, there will be a price for not converting but this benefit is generally reserved for heirs and usually in markets that produce multiples of desired estate goals.

There is a clear benefit to the Roth conversion if one is highly confident that there will be no need to use it for any lifestyle goals at any time in the future and will remain in a high tax bracket throughout retirement. In such cases, conversion clearly makes sense. If one is so over funded for their goals though, this points to a shortage of goals. A Wealthcare advisor would assist the client in identifying what the client wants to achieve with such excess wealth.

The one thing I would caution everyone against is using conversion calculators that relinquish control of the analysis to an over simplified user interface. If the inputs do not require skill, there will be simplified assumptions buried in that simple interface that can lead to highly misleading and costly answers that spit out of the system. Such systems give a false sense of security at the price of sacrificing our clients' lives. If you can't figure out what is really going on under the hood, or the tipping point of where the price and benefits cross in such decisions, contact us and we can lend our expertise to help you make an informed objective decision.

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*A popular industry speaker and writer, DAVID B. LOEPER is the CEO and founder of Financeware, Inc. in Richmond, VA. He is author of the top selling book [Stop the 401\(k\) Rip-off!](#), three other books released in 2009 by John Wiley & Sons ([Stop the Retirement Rip-off](#), [Stop the Investing Rip-off](#) and [The Four Pillars of Retirement Plans](#)) and numerous white-papers. He has appeared on CNBC and Bloomberg TV, served on the Investment Advisory Committee of the \$30 billion Virginia Retirement System, and was chairman of the Advisory Council for the Investment Management Consultants Association (IMCA). Before founding Financeware in 1999 he was Managing Director of Strategic Planning for Wheat First Union. He earned the CIMA® designation (Certified Investment Management Analyst) from Wharton Business School in 1990 in conjunction with IMCA.*

WEALTHCARE RESOURCES

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