Economics-Based Planning

The Do-It-Yourself Roth Conversion Calculator

Laurence J. Kotlikoff and Daniel Royer 04.26.10, 12:39 PM ET

Starting this year, we're all free, at no tax penalty, to withdraw funds from our traditional individual retirement accounts, pay ordinary income taxes due on those withdrawals, and then contribute the amount withdrawn to a Roth IRA.

After you convert, all future growth in the Roth is tax free. So down the road, when we withdraw our Roth IRA balances, we pay no taxes. Moreover, these withdrawals don't count as part of our adjusted gross incomes (AGI). So they can't push us above the nominal AGI thresholds beyond which first 50% and then 85% of our Social Security benefits become taxable under the federal income tax. Hence, coordinating claiming Social Security and Roth withdrawals matters. (Roth withdrawals also don't count for purposes of calculating whether you owe extra income-based Medicare premiums.)

Congress has placed no time limit on the conversion option. Hence, if we don't convert this year, we can do so whenever we want and to whatever extent we want--assuming, that is, Congress doesn't change the law.

But there are two special things about converting this year. One, is that if you convert this year (but this year only) you have the option to recognize and pay tax on all the conversion income in 2010, or to spread it over 2011 and 2012, paying taxes at whatever rates are in effect for those years.

Why else is 2010 different? In past years only taxpayers (individual or couples filing jointly) with modified adjusted gross incomes (MAGI) below $100,000 could convert. Now, beginning this year, everyone can.

This sounds like a Passover question or a gift from the MAGI. But it's in neither the Old nor the New Testaments and has nothing to do with miracles. This policy is the result of Congress acting like Greece--selling a government asset (future taxes on regular IRA withdrawals) for ready cash (larger immediate revenues from taxes on the conversions) in order to announce a lower deficit.

Putting phony fiscal accounting and the national interest aside, is converting in your own personal financial interest?

The answer is not always obvious and is individual to each taxpayer. You pay more taxes in the short run--a bad thing. But you pay less tax in the long run--a good thing. In some cases the advantage is obvious. For example, young taxpayers, who have lower earnings now but expect to have high earnings in the future, are likely to benefit. So too are taxpayers whose earnings are temporarily depressed by special factors, such as business losses, and wealthy folks who want to leave a Roth IRA to children or grandchildren as an income-tax-free inheritance. (For "10 Reasons To Convert To A Roth IRA," click here.)

There are other folks who obviously shouldn't covert, such as those who are planning to move from a high-income tax state, such as New Jersey or New York, to one with no state income tax, such as Florida. (For "Five Reasons Not To Convert To A Roth IRA," click here.)

But for most taxpayers, the answer isn't so clear and can require complex calculations. One reason is that by using the conversion option to change the time pattern of when you recognize taxable income, you can change not only what money gets hit by what tax rates, but also the tax rates themselves. In other words, you can manage, and in some cases dramatically alter, your future tax brackets.

So you need to look before you leap, and very carefully at that. Indeed, to work this out on your own, you need to putatively file all your future tax returns, both federal and state, assuming you do and don't convert. If you're now, say, 55, and could live to 100, that's a prescription for a migraine.

One way to deal with all these calculations is to hire a CPA or financial planner with special Roth conversion software. But there's also a way to do some quick what if calculations on your own, for free.

With ESPlannerBASIC, the economics-based financial planning program our company provides as a free public service at www.esplanner.com/basic, you're looking, thanks to the magic of computers, at several minutes of initial data entry and a two-second calculation to consider the conversion option or a host of other decisions that can safely raise your living standard. (See the note at the end of this column for instructions on implementing the conversion and see www.esplanner.com/learn for tips on using the software to potentially raise your living standard.)

The program does your federal and state tax returns for each future year separately in determining how much you should spend (on a discretionary basis), save, and insure annually to have a stable living standard.

Your living standard is defined as your discretionary spending per household member adjusted for economies in shared living and the lower costs of children. Discretionary spending refers to the spending you do each year after paying your taxes, meeting your housing expenses, making your retirement contributions, and covering other "off-the-top" expenses, such as college tuition and Medicare Part B premiums (calculated based on the government's complex income-related formula).

It's easy to use the program to see if converting, in your case, is a tax blessing or a curse. But as our findings in the tables below illustrate, there's no simple rule of thumb to help every taxpayer. The U.S. tax code is highly complex (what mathematicians would call nonlinear and discontinuous) and small differences in your circumstances can make a big difference in determining whether converting is for you.

Plus you need to think about future tax hikes. Uncle Sam is broke. Indeed, the U.S. is probably in worse fiscal shape than Greece. Hence, higher taxes (of one sort of another) are coming. And future income tax hikes makes converting now more advantageous. Fortunately, ESPlannerBASIC lets you specify future tax hikes.

How do you measure the conversion impact? By running ESPlannerBASIC two ways--once assuming you don't convert and once assuming you do--and then comparing the program's suggested discretionary spending. If the program suggests you can spend more from converting, then converting is worth considering.

Let's consider two 55-year-old North Carolina couples: The 400Ks and The 200Ks. The 400Ks have current annual earnings of $400K, $400K in regular IRAs, and $400K in regular assets. They own a $400K home with a mortgage balance of $200K with 10 years remaining on the mortgage. They pay annual property taxes of $4K, homeowners insurance of $1.5K, and a monthly mortgage of $2.4K. Divide all these figures in half, and you have The 200Ks. Both couples are considering converting half of their IRAs to Roths. Neither couple has a traditional employer-provided pension.

The first table below shows how much each couple's discretionary spending rises or falls if they convert half of their IRAs and use their regular assets to pay the extra taxes.

The results, as you can see, are very sensitive to what's assumed. If there are no tax hikes coming, converting is a modest winner for The 400Ks. But converting is a modest loser for The 200Ks. Both couples, however, do better if they convert, wait until 70 to claim Social Security benefits and withdraw their Roth money last, after they've depleted their traditional IRAs. (For advice on Social Security claiming strategies, click here.)

The second table with a 25% hike (in all tax rates, deductions, exemptions, and other provisions starting when the couples are 65) shows bigger gains and smaller losses (where there are losses) from converting.

If The 400Ks take Social Security at 70 and withdraw from their Roth after depleting their non-converted IRA balances, the couple can spend 1.51% more for the next 55 years. That's a very major living standard gain given that it's all coming out of Uncle Sam's pocket. For The 200Ks, the gain is 0.99%--also nothing to sneeze about.

Sustainable Discretionary Spending--No Tax Hike

	Take Social Security at	Don't Convert	Convert, Withdraw Roth First	Convert, Withdraw Roth Last
The 400Ks	70	$90,814	$91,033 (+0.24%)	$91,397 (+0.64%)
The 400Ks	65	$86,729	$86,967 (+0.27%)	$86,865 (+0.16%)
The 200Ks	70	$58,188	$58,036 (-0.26%)	$58,086 (-0.18%)
The 200Ks	65	$54,666	$53,938 (-1.33%)	$54,035 (-1.15%)

Sustainable Discretionary Spending--25% Tax Hike

Couple	Take Social Security at	Don't Convert	Convert, Withdraw Roth First	Convert, Withdraw Roth Last
The 400Ks	70	$88,268	$89,025 (+0.86%)	$89,602 (+1.51%)
The 400Ks	65	$84,051	$84,849 (+0.95%)	$84,832 (+0.93%)
The 200Ks	70	$56,978	$57,450 (+0.83%)	$57,543 (+0.99%)
The 200Ks	65	$53,362	$53,106 (-0.48%)	$53,262 (-0.19%)

ESPlannerBASIC provides details about each of your future tax returns that let you see where the tax breaks are coming from, when such tax breaks arise. Examining these details is enlightening. Most commentators have suggested that the advantage of converting is greatest for those who are in low tax brackets now and will be in higher ones later. Yet neither of the couples fits that rule of thumb. Both will be in lower tax brackets when they retire even if tax rates are raised by one quarter. But what ESPlannerBASIC also shows is that, by converting, both couples can lower their future tax brackets and, thereby, reduce their future marginal and average tax rates.

So our results urge caution. How much you gain from converting depends on your own economic situation, when you take Social Security, whether tax rates are increased, the general pattern of your marginal tax rates, and your ability to alter your future tax rates. And bear in mind that converting is not a simple decision. Just because your neighbor did it doesn't mean you should, too. If there is one thing we've discovered it's that the advantage to converting is extremely sensitive to people's circumstances. Rules of thumb in this context are rules of dumb.

Note: To use ESPlannerBASIC to evaluate converting, go to www.esplanner.com/basic and run the program assuming you don't convert. Then run it again doing these four things: 1. Reduce your regular IRA balance by the amount you will convert, 2. Increase your Roth IRA balance by the amount you will convert, 3. Enter, under Other Income, the amount you will convert (this other income is assumed to be taxable), and 4. Enter, under Special Expenditures the amount you will convert. Since special expenditures are assumed to be non-tax related, steps 3 and 4 tell the program that your AGI will be higher by the amount you convert. Considering conversions over multiple years in the future requires using one of our detailed calculators, which we sell at www.esplanner.com.

Laurence J. Kotlikoff is a professor of economics at Boston University, president of Economic Security Planning, which provides ESPlannerBASIC for free use at www.esplanner.com/basic, author of Jimmy Stewart Is Dead*, and co-author, with Scott Burns, of* Spend 'Til the End*.*

Daniel J. Royer, Ph.D., is chair of the Department of Writing at Grand Valley State University where he teaches professional and technical writing. He is a writer, content strategist and support specialist at Economic Security Planning.