

# Converting Assets for a Tax-Free Retirement:

## The Roth IRA Conversation

**R**ecall the Mount Everest illustration from an earlier chapter. On the way up the mountain, the accumulation period, advisors are concerned about helping their clients acquire money and ensure their assets are properly allocated to maximize growth while minimizing risk.

However, as retirement commences, and clients begin the descent down the mountain, a different focus emerges—drawing income from those funds. But where should they draw money from first?

Traditionally, retirees have had three retirement income sources from which to choose:

- **Taxable:** CDs, Brokerage Accounts, etc.
- **Tax Deferred:** Traditional IRA, 401(k) or 403(b), Annuities, etc.
- **Tax Free:** Roth IRAs

According to the Retirement Income Certified Professionals (RICP®) program at the American College, retirees should first withdraw money from their taxable accounts—allowing their

traditional IRAs and other tax-deferred accounts to compound for as long as possible before drawing on them. The last source from which to draw income is tax free investments like the Roth IRA. The RICP® gives special emphasis to Roths because their growth is not taxable, they have no minimum required distributions, and they carry specific legacy planning benefits.

IRA expert, PBS show host and CPA, Ed Slott comments,

*Roth IRA distributions to your client's beneficiaries are generally income tax free. And if your client's beneficiary takes a distribution from the inherited Roth IRA after five tax years from the year of your first Roth IRA conversion or tax-year Roth IRA contribution to any Roth IRA, the distribution will be completely income tax and penalty free.*

Clearly having a Roth IRA or converting some your clients' assets to one is a very wise strategy. Let's take a look at what a Roth Conversion did for one couple's retirement.

### CASE STUDY: Roth IRA Conversion



**Client Overview:** Calvin and Claire (65) are fairly comfortable with their retirement income plan. However, they are somewhat concerned about living longer than they've planned for and the impact future tax rates may have on their savings, should they need to use them, or on their estate should they pass it on.

Financial Position:

- \$200,000 Traditional IRA | \$400,000 401k/Annuities | \$100,000 in Brokerage Account
- \$450,000 Home | \$50,000 Mortgage | \$541/Month Payment

**Planning Objective:** Convert a portion of Calvin and Claire's tax deferred IRAs into a tax-free Roth IRA for future use, or as an inheritance, while preserving the most amount of principal.

The advisor can begin the Roth Conversion conversation with their clients by exploring three questions:

**Do you need the money in your traditional IRA immediately or in the future?**

If future, then proceed.

**Are you concerned that you may be in a higher tax bracket in the future?**

If yes, then proceed.

**Do you have the money to pay the taxes on the conversion?**

If they are not sure, proceed.

### Three Options for Paying the Conversion Taxes

Let's say the taxes to roll over the \$200,000 traditional IRA will be \$48,000. Your clients have a few choices regarding the accounts they could draw from.

- **They could pay the taxes out of the roll over itself.** Instead of rolling over \$200,000, they roll over \$152,000, but then they don't receive the full benefit of the transaction.
- **They could take it from their existing IRA or other taxable accounts.** Doing so would mean paying taxes on the IRA distribution as well as incurring the lost opportunity costs from drawing the money early instead of allowing it to continue compounding.

Herein lies the challenge; many people don't have a viable source to pay the conversion taxes, or they need those funds to live on. Simply stated: If you don't have money to pay the tax, you can't convert. However, there is another option.

### Use Your Housing Wealth

We know that the majority of older Americans and emerging baby boomers are sitting on a source for paying Roth Conversion taxes: their homes!

How can Housing Wealth be used to pay the taxes for a Roth IRA conversion? The process is easier than you may think.

**Step 1:** Calculate their HECM benefit. After paying off the \$50,000 mortgage on their \$450,000 home, the HECM makes a \$118,000 line of credit available. [www.HecmCalculator.net](http://www.HecmCalculator.net)

**Step 2:** Determine if they want to pay the taxes all at once, over a 5-year period, or over a 10-year period (for example). If they decide to pay over 5 years, they would draw \$9,600 each year from the HECM line of credit. If over 10 years, \$4,800 per year.

The charts below demonstrate four things: (1) The growth on the initial line of credit if it were left untouched, (2) the growth on the line of credit if they were to take out \$48,000 up front, (3) the growth if they were to take out \$9,600 a year over a 5-year period, or (4) the growth if they were to take out \$4,800 a year over a 10-year period.

#### Line of Credit Left Untouched

Age	Beginning of Year Balance	Growth (%5)	End of Year Balance
65	\$118,000.00	\$5,900.00	\$123,900.00
70	\$150,601.22	\$7,530.06	\$158,131.29
75	\$192,209.57	\$9,610.48	\$201,820.04
80	\$245,313.53	\$12,265.68	\$257,579.20
85	\$313,089.13	\$15,654.46	\$328,743.59
90	\$399,589.88	\$19,979.49	\$419,569.38

#### Line of Credit Growth with One-Time Tax Payment of \$48,000 in 1<sup>st</sup> Year

Age	Beginning of Year Balance	Growth (%5)	Withdrawal	End of Year Balance
65	\$118,000.00	\$5,900.00	\$48,000.00	\$75,900.00
70	\$92,256.92	\$4,612.85	\$0	\$96,869.77
75	\$117,745.81	\$5,887.29	\$0	\$123,633.10
80	\$150,276.81	\$7,513.84	\$0	\$157,790.65
85	\$191,795.52	\$9,589.78	\$0	\$201,385.30
90	\$244,785.09	\$12,239.25	\$0	\$257,024.34

### Line of Credit Growth with Taxes Paid Over 5-Year Period

Age	Beginning of Year Balance	Growth (%)	Withdrawal	End of Year Balance
65	\$118,000.00	\$5,900.00	\$9,600.00	\$114,300.00
66	\$114,300.00	\$5,715.00	\$9,600.00	\$110,415.00
67	\$110,415.00	\$5,520.75	\$9,600.00	\$106,335.75
68	\$106,335.75	\$5,316.79	\$9,600.00	\$102,052.54
69	\$102,052.54	\$5,102.63	\$9,600.00	\$97,555.16
70	\$97,555.16	\$4,877.76	\$0	\$102,432.92
75	\$124,507.86	\$6,225.39	\$0	\$130,733.25
80	\$158,907.08	\$7,945.35	\$0	\$166,852.44
85	\$202,810.18	\$10,140.51	\$0	\$212,950.69
90	\$258,842.89	\$12,942.14	\$0	\$271,785.04

### Line of Credit Growth with Taxes Paid Over 10-Year Period

Age	Beginning of Year Balance	Growth (%)	Withdrawal	End of Year Balance
65	\$118,000.00	\$5,900.00	\$4,800.00	\$119,100.00
66	\$119,100.00	\$5,955.00	\$4,800.00	\$120,255.00
67	\$120,255.00	\$6,012.75	\$4,800.00	\$121,467.75
68	\$121,467.75	\$6,073.39	\$4,800.00	\$122,741.14
69	\$122,741.14	\$6,137.06	\$4,800.00	\$124,078.19
70	\$124,078.19	\$6,203.91	\$4,800.00	\$125,482.10
71	\$125,482.10	\$6,274.11	\$4,800.00	\$126,956.21
72	\$126,956.21	\$6,347.81	\$4,800.00	\$128,504.02
73	\$128,504.02	\$6,425.20	\$4,800.00	\$130,129.22
74	\$130,129.22	\$6,506.46	\$4,800.00	\$131,835.68
75	\$131,835.68	\$6,591.78	\$0	\$138,427.47
80	\$168,259.45	\$8,412.97	\$0	\$176,672.42
85	\$214,746.43	\$10,737.32	\$0	\$225,483.76
90	\$274,076.91	\$13,703.85	\$0	\$287,780.76

**Did we meet the planning objective?** Convert a portion of Calvin and Claire's tax deferred IRAs into a tax-free Roth IRA for future use, or as an inheritance, while preserving the most amount of principal. I think we did!

By using the HECM to pay all (or even some) of the taxes for the conversion we were able to:

- Convert the entire \$200,000 into tax free savings for their retirement needs, or for their heirs.
- Give continued access to HECM Line of Credit even AFTER the conversion.

You may have clients in mind who have considered a Roth Conversion, but have not been able to pay the taxes in a way that makes financial sense. Now, you have another option for them consider - Housing Wealth. Is this worth a conversation?