REAL WORLD PLANNING IDEAS FOR REAL PEOPLE

ROTH IRA'S: TO CONVERT OR NOT TO CONVERT....THAT IS THE QUESTION

AN ARTIFEX FINANCIAL GROUP WHITE PAPER

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"To be or not to be, that is the question:

Whether 'tis Nobler in the mind to suffer

The slings and Arrows of outrageous Fortune,

Or to take Arms against a Sea of troubles..."

--William Shakespeare, the first four lines of Hamlet's most famous soliloquy

About Artifex Financial Group

Artifex Financial Group was established in 2006 by me and my business partner, Darren Harp with the goal of helping middle class and affluent clients establish sound financial plans and manage their money in a manner consistent with their goals and dreams. When Artifex opened its doors, I had spent 19 years in the financial services field, Darren had 8 years of experience, and we were both fed up with the current state of the industry. We had both seen our share of fiduciary conflicts, investment mismanagement, and just poor advice coming from some of the most respected firms in the business. We pledged then and there to provide the following service to their clients:

- The firm would be established to primarily care for the middle class. Since Dayton, Ohio is where the firm started, we believe that the region we operate in is primarily composed of middle class families and individuals. The investment and financial planning profession has typically overlooked this market and provided it with the worst advice.
- We would no longer hold licenses to sell any products, and would adopt the National Association of Personal Financial Advisors pledge to be Fee-Only and fiduciaries for our clients. This has proven to be the right strategy for us, and one we wish we had adopted 10 years ago. Not only do we sleep better at night, knowing that we do not have any conflicts of interest and that our decisions are always in the client's best interest, but we believe that independence and objectivity result in better results for our clients.
- We maintain a skeptical view of any product provider, service provider, financial salesperson, Wall Street firm, mutual fund family, insurance provider, etc. who want access to our clients' money. We are gatekeepers for our clients. We know the dark corners and dirty secrets of the profession, and will use our knowledge to our clients advantage.
- As much as we love the business, we will treat it as a business, as we need to perpetuate our advice for generations to come. Furthermore, our advice and experience has real value for people, and we should never be afraid to be paid appropriately for it.

We are pleased with the results thus far. We've grown to serve 130 clients, over 300 accounts, over $60,000,000 in assets managed, 2 office locations and now employ 6 individuals who share the same vision we have. If you do not have a relationship with a fiduciary financial advisor, we invite you to contact us to explore how we might serve a role on your personal financial team.

----Doug Kinsey, Partner

About the Authors

Doug Kinsey, CFP®, AIFA®, CIMA®

Doug Kinsey is a founding partner of Artifex Financial Group and serves as a client advisor and Chief Investment Officer of the firm. Doug has over 25 years of experience in financial services, including a background in investments, insurance, and banking. In addition to being a Certified Financial Planner certificant since 1999, Doug also holds the Accredited Investment Fiduciary Analyst and Certified Investment Management Analyst designations.

John Girvin, CFP®, EA

John is a Senior Financial Planner and Director of Tax and Financial Planning for Artifex Financial Group.

In addition to being a Certified Financial Planner certificant, he has also earned the Enrolled Agent designation from the IRS. As such, John is responsible for tax planning, tax preparation and financial planning strategies for the clients of Artifex Financial Group.

John entered the financial planning business in 1995, and operated his own fee-only consulting firm prior to joining Artifex Financial Group in 2010.

Why are we writing this?

Over the last few years, there has been a lot of press dedicated to the topic of Roth IRA conversions. Few people have a thorough understanding of IRA's (Individual Retirement Accounts), let alone Roth IRA's. To truly appreciate the potentially powerful Roth IRA and how it can impact your future financial health, we thought it was necessary to put some of our current thinking in writing. This is not meant to be an exhaustive analysis of Roth IRAs and conversions to Roths from traditional IRA's, as the answer is very dependent on each individual's personal and financial situation.

It is our intention for this white paper to serve as a starting point for you in evaluating your circumstances and perhaps in framing a conversation with your financial planner. The question of whether or not to convert an IRA to a Roth IRA is just one of many issues that we encounter on a daily basis with our clients.

What is an IRA?

The term "IRA" simply refers to "individual retirement account", it is not an investment or a product, it is a type of account intended for retirement savings and investing that has the blessing of the IRS. As long as certain rules are adhered to, the IRA has some terrific benefits, and a few limitations:

1. Money contributed to a traditional IRA account is done on a "pre-tax" basis. That is, you do not have to pay tax on it, and it serves as a deduction from your income for the year of contribution, within certain limits. The ability to take this deduction is based on two things -

   a. If you (or your spouse, if married) is covered by a corporate retirement plan. If you are not covered by a corporate retirement plan, you can contribute the full amount, without regard to your income.

   b. If you are covered by a corporate retirement plan, your MAGI (Modified Adjusted Gross Income)

IF YOUR 2018 FEDERAL INCOME TAX FILING STATUS IS	YOUR IRA DEDUCTION IS REDUCED IF YOUR MAGI IS BETWEEN:	YOUR DEDUCTION IS ELIMINATED IF YOUR MAGI IS:
Single or head of household	$63,000 - $73,000	$73,000 or more
Married filing jointly or qualifying widow(er)	$101,000 - $121,000 (combined)	$121,000 or more (combined)
Married filing separately	$0-$10,000	$10,000 or more

2. Capital gains, income, dividends, etc. are sheltered from taxation until withdrawn. At withdrawal (normally at retirement, but sometimes sooner), any money distributed from a traditional or regular IRA is taxed at your ordinary income tax rate (unless it was money contributed "after-tax", which is normally not recommended).

3. You can contribute up to $5,500 to a traditional IRA, unless you are age 50 or over, and then the limit is $6,500.

4. You must be under age 70 1/2. No contributions can be made to your IRA upon reaching that age.

5. You must receive taxable compensation (wages, salaries, commissions, self-employment income, taxable alimony or separate maintenance) during the year.

6. Distributions made before age 59 1/2 may be subject to a 10% penalty tax, and ordinary income tax.

7. You may roll over money from another IRA or corporate retirement plan into a traditional IRA account.

8. You must begin taking distributions from your IRA by April 15 of the year following the year you turn age 70 1/2 (Required Minimum Distributions). These distributions are subject to ordinary income tax rates.

9. Your heirs must continue taking distributions from an inherited IRA

10. Distributions for qualified higher education expenses for yourself, your spouse our you or your spouse's children or grandchildren may avoid the 10% penalty. Income tax will still apply.

What is a Roth IRA?

Like a traditional IRA, a Roth IRA is an Individual Retirement Account with unique features. The primary benefit of a Roth is that **money distributed from a Roth is not taxed, unlike a traditional IRA**. The trade-off here is that money contributed TO a Roth is not tax-deductible. In other words, you pay the tax up-front on money contributed to a Roth IRA, in exchange for tax-free distributions of both principal and earnings in the future.

For many people, the tax deduction today is more important than the tax paid later. However, with our changing economic and tax landscape in the United States, more attention has been paid to Roth IRAs recently. This is due to the "tax leverage" that can be accomplished by crafting a prudent IRA strategy with both types of IRA's. If you think (as we do) that our tax structure will probably not be any more beneficial than it is today, and that individual rates are almost certain to increase no matter who gets elected, then you need to strongly consider funding a Roth IRA account, either on a pay-as-you-go basis, or as a structured conversion.

Characteristics of Roth IRA's:

1. You can contribute up to the lesser of $5,500 ($6,500 if you're age 50 or older) or 100% of your taxable compensation to a Roth IRA. You may also be able to contribute up to $5,500 to a Roth IRA in your spouse's name even if he or she receives little or not taxable income ($6,500 if your spouse is 50 or older). However the amount you can contribute is - you guessed it - limited by your MAGI. And no, MAGI is not MAGICAL! It's quite the opposite:

IF YOUR FEDERAL FILING STATUS IS:	YOUR ROTH IRA CONTRIBUTION IS REDUCED F YOUR MAGI IS:	YOU CANNOT CONTRIBUTE TO A ROTH IRA IF YOUR MAGI IS:
Single or head of household	More than $120,000 but less than $135,000 (for 2018)	$135,000 or more (for 2018)
Married filing jointly or qualifying widow(er)	More than $189,000 but less than $199,000 (for 2012)	$199,000 or more (for 2012)
Married filing separately	More than $0 but less than $10,000	$10,000 or more

2. You must receive taxable compensation during the year. Same as in item "5" under IRA's in the previous section. Members of the Armed Forces can include nontaxable combat pay as part of their taxable compensation when determining how much they can contribute to an IRA. This may increase the viability of selecting a Roth as opposed to a traditional IRA for these taxpayers.

3. Total contributions to ALL IRA's cannot exceed the annual limits. Therefore, you cannot contribute $5,000 to both types of IRA. It's $5,000 total (or $6,000, if age 50 or over).

4. Qualified distributions from a Roth IRA are completely tax free. To be qualified,the distribution must be no earlier than 5 years after establishing the Roth IRA account (notice it says "establishing", not FUNDING). AND one of the following ALSO applies:

i. You have reached age 59 1/2 by the time of the withdrawal

ii. The withdrawal is made due to a qualifying disability

iii. The withdrawal is made for first-time homebuyer expenses ($10,000 lifetime limit)

iv. The withdrawal is made by your beneficiary or estate after your death

5. Funds used to pay higher education expenses, as with a traditional IRA, are exempted from the IRS penalty, and only the earnings on the account are taxed at ordinary income rates, in such a case.
6. There are additional penalty exemptions (not income tax exemptions) if funds are used for medical insurance premiums in the event of job loss, unreimbursed medical expenses over the 7.5% AGI requirement, and in the case of distributions that are part of a series of substantially equal payments (as in the case of traditional IRA's)
7. In any event, if a Roth distribution is deemed "non-qualified", only the earnings on the account are taxed.
8. You do not ever have to take a distribution from a Roth IRA account. There is not a Required Minimum Distribution rule. I repeat. NO RMD!
9. If you intend for beneficiaries to inherit part of your IRA, they will not pay federal income tax on your Roth IRA (assuming it was established at least 5 years prior to death).

To Convert or Not to Convert?

So maybe by now you are thinking that you like some of the features of the Roth IRA, and maybe you're wondering "how can I get the maximum benefit of this tool, given the fact that I have very little invested in my Roth IRA (or maybe haven't even established one yet)".

One answer may be to convert all or a portion of your traditional IRA account to a Roth IRA. The decision deserves a little number-crunching, because what may make sense for one person, may be totally ridiculous for another. This is primarily because the conversion itself creates ordinary income in the year of conversion. So your tax bill is going to increase for that year, and possibly be pushed into a higher tax bracket. This downside has to be weighed against the potential upside in future years. The inputs in this analysis include the following:

1. Your age. The longer your life expectancy or years to retirement, the more a conversion may make sense.

2. Your current tax bracket, and your expectations of future tax rates. If you are currently in a lower income bracket, the immediate taxes incurred will present less of a problem. Also, if rates creep up in the coming years, this will effect the analysis, positively or negatively, depending on your particular situation. Keep in mind that the amount converted will be looked at as income, so you may be pushed into a higher bracket, or you may want to convert only the maximum amount to keep you in the same bracket. This will also effect your state and local taxes.

3. Can you pay the tax due from other, taxable accounts? This is the most effective way to do this. You want to avoid paying income tax from the amount converted, as you would be diminishing your funds that you are setting aside for unrestricted growth (no future taxes) inside the Roth.

4. Do you have a substantial portion of your retirement assets inside traditional IRA's and pension plans? If so, your income tax exposure is high, since money inside of 401k plans, traditional IRA's, and annuities is subject to income tax rates, whereas money in taxable (individual and joint) and Roth IRA accounts is not.

5. The size of your estate. If you have a large estate with significant assets in tax-qualified investments, and would like to pass along a certain portion of your estate to your heirs in a tax-favorable manner, then a Roth conversion becomes more important. Additionally, by paying the income tax now, the estate will not owe income tax on this asset at your death.

6. Can you leave funds in your Roth IRA for at least 5-10 years? The normal "breakeven" period (time it takes to recover the tax paid on conversion) is in this timeframe. If you can't commit to keeping the assets in the Roth for that long, then the whole exercise could be for naught. However, if you don't liquidate the entire account, there will probably be some benefit.

7. Will you apply for college financial aid in the next few years? By using assets to pay federal income tax now, you are effectively removing those dollars from assets to be considered in determining your child's eligibility for financial aid.

8. Can you live comfortably in retirement without taking IRA distributions? We have several clients who are in this scenario, due to good planning on their part and sound investment management on our part. For these folks, converting some IRA assets to Roth IRA assets makes sense as they will reduce or eliminate the necessity of RMD's and they will provide an income-tax free asset to their heirs.

Examples:

In example 1, we have a client who is a widow, with significant taxable assets and a smaller IRA account. The IRA will probably never be used in the current plan, but will present the client with the necessity of taking Required Minimum Distributions, which will be taxed at her current income tax rate. The analysis involves the following questions:

1. Will she use the IRA assets, or will the RMD's simply be added to her taxable investment account?
2. Would she like to pass this asset on to her heirs?
3. How many more years to her expected mortality age?
4. What is the expected rate of return?
5. What are our expectations about future tax rates?

In a nutshell, what the spreadsheet shows us is:

1. It will take this client 7 years to break even given the following:
    a. Converting the entire IRA in one year, 2012
    b. A conservative rate of return of 5% is applied to the tax paid, the tax savings from not taking RMD's,   the IRA, and the Roth IRA.

If the client chooses to only convert the amount of her traditional IRA that keeps her in the 25% tax bracket, an alternative analysis shows that the payback period is 5 years on the amount that was converted. She could convert about $54,000 of her existing IRA and stay in the 25% bracket, given her other income. She could also choose to convert partial amounts of her IRA over several years, but this ultimately will extend her payback period.

(Note: The examples were completed in 2012, and have not been updated. The process for analyzing the appropriateness of Roth conversions is still the same, however. We are simply showing some of the steps involved in making the best decision).

Example #1:

Social Security Income	17238				
Total IRAs	249000				
INCOME	10% 8.5k	15% 34.5k	25% 83.6k	28% 174.4k	33% 380k
Earned Income/IRA	9600				
Social Security @ 85%	14652.3				
Investments	16600				
Roth IRA Conversion	0	4597.7	53697.7	144497.7	249000
Projected RMD		9776.092	7812.092	4180.092	0
DEDUCTIONS					
Standard	5800				
Over 65	1450				
Exemptions	3700				
Taxable	29902.3	34500	83600	174400	278902.3
Tax Due	4064	4756	17032	42456	76941
INCOME	10% 8.5k	15% 34.5k	25% 83.6k	28% 174.4k	33% 380k
Social Security @ 85%	14652.3				
Additional Income	16600				
IRA RMD	9960	9960	9960	9960	9960
Maximum Roth Conversion		4237.7	53337.7	144137.7	349737.7
DEDUCTIONS					
Standard	5800				
Over 65	1450				
Exemptions	3700				
Taxable	30262.3	34500	83600	174400	380000
Tax Due	4116	4756	17032	42456	76941
33% Differential	72825				
Years to break even	7	72119.25			
Conversion @ 5% less return on differential	61661.25				
RMD Tax Savings	10458				

Example 2:

In example 2, we have a client who is married and files a joint return with his spouse. A significant portion of his investment accounts are in traditional IRA's as opposed to taxable accounts. The client currently has no need for the IRA assets, but will be required to take distributions of close to $70,000 per year at age 70 1/2. Current income is subject to a 15% bracket, but taking RMD's will push him into the 25% bracket. The client may also wish to have assets transfer to heirs income tax-free. The same analytical questions apply as in Example 1.

What this analysis shows is:

1. With such a large percentage of assets in a traditional IRA, the projected RMD will shift him into a higher tax bracket.
2. By converting part of the IRA to a Roth, he reduces the RMD by approximately approximately 22% or $15,000 per year, saving him about $4,000 per year in taxes.
3. He can remove $360,000 from the traditional IRA which will grow fully tax-free and be passed on to heirs.
4. His payback period is 5 years.

Example 2:

INCOME		15% Bracket 70k	25% 140k	28% 212k	33% 380k
Social Security @ 85%	35700				
Investments	5000				
Roth IRA Conversion	0	49000	119000	191000	359000
Projected RMD		66040	63240	60360	53640
DEDUCTIONS					
Standard	11600				
Over 65	1150				
Exemptions	7400				
Taxable	20550	69550	139550	211550	379550
Tax Due	2229	9631	27131	47300	102700

INCOME		15% Bracket 70k	25% 140k	28% 212k	33% 380k
Social Security @ 85%	35700				
Investments	5000				
IRA RMD $1.7 mil	68000	68000	68000	68000	68000
Roth Conversion		-18550	51450	123450	291450
DEDUCTIONS					
Standard	11600				
Over 65	1150				
Exemptions	7400				
Taxable	88550	88550	140000	212000	380000
Tax Due	14394	14394	27200	47300	102700
Maximum Differential	88306				
Break Even 5 yrs	85623.5				
Conversion @ 5% less return on differential	67673.5				
RMD Tax Savings	17950				

In Conclusion

These are not meant to be exhaustive examples, but are taken from real-life cases to illustrate the type of analysis that we go through to reach a recommendation for our clients. These decisions are very dependent on an individual's personal situation, as well as the assumptions used. For example, a higher rate of return will shorten the "payback" period, as will higher future tax rates. Lower rates of return or lower future tax rates would serve to extend the payback period.

Nobody has a crystal ball, including financial analysts and planners, but the value of having a fiduciary financial advisor is that you can actually have an informed discussion without fear of a hidden agenda, or being sold something as the "solution" to your problem.

At Artifex Financial Group, we advise you to NOT accept the "slings and Arrows of outrageous Fortune" but instead to arm yourself against the potential "Sea of troubles" presented by the economic necessities of the United States. Take some time now to talk with us to make sure your retirement is properly planned.

Best wishes for a successful financial future!