

# Money Matters

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## Skloff Financial Group Question of the Month

By Aaron Skloff, AIF, CFA, MBA

**Q: What are the top 10 most frequently asked questions about in-plan Roth conversions – Part 1?**

### **The Problem – A Lack of Tax-Free Income in Retirement**

Many retirees are faced with the unexpected curse of high taxable income and high taxes in retirement. Why is it a curse? Because high taxable income results in high tax brackets and high Medicare premiums for married couples, and even higher tax brackets and Medicare premiums for single filers and widows/widowers.

### **The Solution – In-Plan Roth Conversions**

In-plan Roth conversions (i.e.: pre-tax contributions/earnings and/or after-tax contributions/earnings), like Roth IRA conversions, allow you to convert taxable assets into tax-free assets. If in-plan Roth conversions are completed in lower income years, the additional income on the amount converted may not alter your income tax bracket. If conversions are completed more than two years before starting Medicare, your income from that year's conversion will not be used to determine your Medicare premiums. Withdrawals from Roth accounts, such as a Roth 401(k) or Roth IRA, are tax free. They are an ideal source of tax-free income in retirement. Here are the top 10 most frequently asked questions and answers about in-plan Roth conversions. Part 1 of this article covers 1-5, Part 2 covers 6-10.

**1. Why complete an in-plan Roth conversion if the converted assets are taxed?** In-plan Roth conversion can provide tax arbitrage – legally paying less taxes. If conversions are completed in increments, the additional income may be modest enough to retain your income tax bracket and tax rate. For example, if your joint taxable income (gross income, less your standard deduction and other adjustments) plus the amount you converted was between \$20,551 and \$83,550 in 2022, your conversion amount would be subject to a 12.0% federal income tax rate. If you were single or waited until you were single or a widow/widower, and your income plus the amount you converted was between \$41,776 and \$89,075 in 2022, your conversion would be subject to a 22.0% federal income tax rate. **For perspective, 22.0% is 83.3% more than 12.0%.**

If you believe you will be in a higher income tax bracket in the future due to a higher income and/or single versus joint filing status and/or Congress simply increasing tax rates (as proposed in many bills), converting some of your pre-tax assets could help you avoid paying 83.3% or more, depending on your situation.

**2. Could it benefit your heirs?** Due to the SECURE Act, heirs (except for your spouse) that inherit a pre-tax retirement account after 12/31/19 must withdraw the accounts within the 10th year following the year of the plan participant's death ("10-year rule"). While you may be subject to a 12.0% federal income tax rate, the rapid withdrawal requirement adds income to a high earning heir's income, which could push them into a 37.0% federal income tax bracket. **For perspective, 37.0% is 208.3% more than 12.0%.**

Although your heirs (except for your spouse) are still subject to the 10-year rule on Roth assets, they will surely be delighted in avoiding a potential 37% or even higher federal income tax rate if tax rates increase on their Roth withdrawals, since they receive them tax free.

**3. Are there assets or income limits?** There are no asset or income limits. You can convert \$1 or \$1 million of your assets, or 1 share or 1 million shares of stock. There are no income limits either. Your pre-conversion income could be \$1 or \$100 million. As described above, the higher your taxable income (including the conversion), the higher your income tax rate.

**4. Will your retirement plan custodian withhold taxes?** Your retirement plan custodian may not withhold taxes on the conversion. If they do not withhold taxes, you will be responsible to pay taxes when you file your taxes for year you completed the conversion. Based on your situation, you may have to instead pay estimated quarterly taxes.

**5. Can a conversion be undone?** No. Once you complete a conversion it cannot be undone. The same way you invested in your retirement plan bi-weekly over 5,10,20 or 40 years, you should convert gradually. That way, you do not convert too much at the wrong time and create a problem that cannot be fixed.

### **Action Steps – Complete In-Plan Roth Conversions to Create Tax-Free Income in Retirement and Protect Your Heirs**

Work closely with your Registered Investment Adviser (RIA) to reduce your taxes, and grow and preserve your wealth.

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