How Do You Make the Tax Cost Calculation?

Please note the next section is fairly technical. I had seriously considered omitting this section and selling it separately for a premium to CPAs and other financial professionals. Many, if not most readers will find this tough going. This is a section that if you have the right advisor, you could possibly skip. The place to skip to is the Kevin and Debbie Smith story.

Frankly, however, we don't know an easier way to help you determine an appropriate amount to convert to a Roth IRA. Having an income tax preparation software program such as Turbo Tax or Tax Cut or one of the other income-tax preparation software programs will make it easier to calculate how much of a Roth IRA conversion you should make. You could do it manually without an automated tax preparation software program, but it makes the job much tougher.

In some cases, simply referring to the tax bracket amounts for the current year and following the "starting point advice" in Chapter Three may be all that is needed. That method, however, though a good starting point, is unlikely to give you the most advantageous conversion amount.

One problem with the simple analysis presented in Chapter Three is that it does not take into account many of the tax complications and nuances in the tax code. As you increase the Roth IRA conversion amount, you certainly increase taxable income, but not necessarily dollar for dollar. The additional income from the Roth IRA conversion might distort other tax attributes. If you don't take into consideration their separate tax treatment, you will calculate a less than optimal amount to convert to a Roth IRA. Also, I am not talking about $100—or even $1,000—dollar miscalculation. Not taking into consideration some of the factors below could cost the IRA owner thousands of dollars, if not tens of thousands of dollars. Sometimes, these factors are the difference between making it advisable vs. inadvisable to do a Roth IRA conversion. It happens not infrequently that adding an additional dollar of Roth IRA conversion income may increase your taxable income more than you had anticipated. The following list of items lists income-sensitive areas of the tax code that need to be included in your Roth IRA conversion strategy:

- the taxability of Social Security income
- the alternative minimum tax
- the loss of itemized deductions and personal exemptions
- the loss of rental loss deductions
- the loss of various tax credits allowed for lower income taxpayers
- the additional Medicare tax on Social Security income in 2012 based on higher 2010 income
- state income tax considerations
- special long-term capital gains treatment
- special treatment for qualifying dividends

So, here we go.

Start by getting a tax software program and entering all of your projected items of income and expenses. Most of the software programs aren't available until after year end. Since we are doing projections, you will have to use last year's tax software. In fact, if you used a tax software program to prepare your 2009 tax return, that is a fine starting point for your 2010 projections, since the 2010 tax laws are similar to the 2009 tax laws. The tax brackets did not change much for 2010, and Social Security income is generally the same as the prior year. So, if you are reading this in calendar year 2010, use a 2009 version of the tax software, but use 2010 income and deduction amounts. Of course there will be different rules for 2010 than 2009, but we are going to make do. It will be a bigger problem in 2011 because the tax rates for 2011, particularly the upper income brackets, are higher than those of 2010.

In many of the calculations we have done, we have found that it makes sense to recognize the income from the 2010 conversion in 2010 rather than deferring the income to 2011 and 2012. This is because for many:
- the tax rates could be higher in 2011-2012;
- their other income may be higher than in 2010;
- you can stay in an existing tax bracket for three years instead of a lower one for one year and a higher one for the other two years.

For example, please assume you are in the 15% bracket and you have another $15,000 per year that you could convert and stay in the 15% bracket. Let's assume you want to convert $45,000 in the next three years. If you convert the $45,000 in 2010, you will have the choice of adding $45,000 of your income in 2010 or recognizing $22,500 in 2011 and $22,500 in 2012. No matter how you do it, at least some of that money will be taxed at the 25% bracket.

If you convert $15,000 per year, you will be in the 15% bracket for the entire amount that is converted.

For now, we will skip the additional considerations resulting from deferring the 2010 conversion income into 2011-2012. To recognize the income in 2010, the taxpayer must make an election on his or her income tax return by the due date of the return plus extensions.

So, let's assume you have entered all your projected items of income and expense for 2010 in a 2009 tax software package. Start by assuming no Roth IRA conversion. This is the control or status quo number.

Then, we would suggest adding income in different amounts representing different amounts of Roth IRA conversions. You could start by adding $10,000 to your income if you are looking at small conversions. You could start by adding $100,000 if you think a large conversion would be appropriate.

I would prefer you start small. Let's assume you start by testing the additional taxes due on a $10,000 Roth IRA conversion. Then, the idea is to determine the extra tax on additional income on the amount converted. Using a 2009 tax form (as it is the most current form available), you would start by adding $10,000 to line 15b. In your tax-preparation software, there is a line to add income from a Roth IRA conversion and that same amount should show up on line 15b. That amount, if there is nothing tricky going on, should also add $10,000 to line 22, total income. What I mean by something "tricky" I mean adding one dollar of Roth IRA conversion does not add one dollar of taxable income taxes at ordinary income tax rates. Examples are in the "list several" pages ago starting with social security several pages. Also, if there is nothing tricky going on, that should add $10,000 to line 37, adjusted gross income. Finally, it should add $10,000 to line 43—taxable income.

One of the points of this exercise, however, is that there may very well be something tricky going on. It might be one of the items listed above or it could be something else.

To try to cover all the possibilities with some type of formula would be too hard so I am in effect recommending calculating your tax rate "manually" for different amounts of Roth IRA conversions.

Let's start with an example. Let's make the following assumptions:

Income items:

wages (only one spouse)	$ 6,000
interest income	1,000
qualified dividend income	8,000
net long-term capital gain	20,000
pension income	25,000
gross Social Security income (only one spouse)	25,000

Deductions:

gross medical expenses	15,000
real estate taxes	10,000
state and local taxes paid	7,000
mortgage interest	7,000
charitable contributions	9,000
miscellaneous itemized deductions	20,000

Then, whether there is something tricky going on or not, have the program calculate your tax. Starting with making the calculation with no conversion, you should calculate there would be a $446 tax (That number would appear on line 60 of the second page of the Form 1040).

Then, the idea would be to add different conversion amounts and see the results. To start, let's add $10,000 to line 15b and see what the impact is on both taxable income and,

more importantly, your taxes. In this way, the total taxes on the conversion can be calculated and expressed as a percentage of the conversion. The new tax with the additional $10,000 of Roth IRA conversion income would be $1,541. Now subtract the $1,541 from the $446 which was the tax with no Roth IRA conversion. The extra or delta in taxes is $1,541 minus $446 or $1,095. So, for an extra $10,000 in a Roth IRA, you have to write a check for $1,095 to the IRS. In effect, the tax bracket for the $10,000 conversion was 10.95%.

Now, let's test a Roth IRA conversion of $20,000. Again, you would add $20,000 to line 15b. You would find that the additional $20,000 would result in a $3,179 tax. Then you compare the $3,179 in tax on the $20,000 conversion to the $1,541 tax if you made a $10,000 conversion. The difference, $1,638 is the extra tax on the additional $10,000 conversion over and above the first $10,000 conversion. It is more meaningful to compare the tax at each level you test to the previous level, rather than comparing it to doing nothing.

So, the effective or marginal tax bracket for that second $10,000 conversion is 16.38%.

The taxes on each increment of the Roth conversion can also be calculated and expressed as a percentage of the conversion. If you really want to determine the optimal Roth IRA conversion amount, we would recommend you follow this exercise or pay someone to do it.

By actually calculating the taxes using the Form 1040 itself, we will not be misled by any of the "tricky" factors and it will take into account the following items:

- Federal ordinary income tax
- Federal alternative minimum tax
- Credits such as foreign tax credit and Schedule M (Making Pay Work) credits
- State income tax, net of credits (if state taxes are applicable)
- Medicare tax on Social Security income in 2012 (for 2010 conversions)

Here is an example of these tax calculations:

Roth Conversion Amount	Total Taxes, Net	Overall Conversion Tax %	Total Extra Tax Created By the Conversion	Incremental Conversion	Incremental Conversion Tax %
0	446				
10,000	1,541	10.95%	1,095	10,000	10.95%
20,000	3,179	13.67%	2,733	10,000	16.38%
30,000	4,822	14.59%	4,376	10,000	16.43%
40,000	6,464	15.05%	6,018	10,000	16.42%
44,000	7,117	15.16%	6,671	4,000	16.33%
45,000	7,399	15.45%	6,953	1,000	28.20%
50,000	8,907	16.92%	8,461	5,000	30.16%
60,000	12,889	20.74%	12,443	10,000	39.82%
80,000	18,438	22.49%	17,992	20,000	27.75%
100,000	24,629	24.18%	24,183	20,000	30.96%
115,000	30,565	26.19%	30,119	15,000	39.57%
120,000	32,190	26.45%	31,744	5,000	32.50%
160,000	46,781	28.96%	46,335	40,000	36.48%
200,000	60,584	30.07%	60,138	40,000	34.51%
350,000	114,675	32.64%	114,229	150,000	36.06%
450,000	145,564	32.25%	145,118	100,000	30.89%
500,000	163,300	32.57%	162,854	50,000	35.47%
1,000,000	342,860	34.24%	342,414	500,000	35.91%

For every conversion analysis, it is important to consider not just the total tax on the total conversion, but rather the tax on each increment of Roth conversion comprising the total. In the above example, a $60,000 conversion is broken down into several increments. There are three increments of testing conversions of $10,000, $20,000 and $30,000. There is another at $14,000, at $6,000, etc. The first $10,000 increment is taxed at 10.95%. The second $10,000 increment is taxed at 16.38% and so on. In total, the average total tax on the entire $60,000 conversion is 20.74%.

What we find in the above situation is that there is a big increase in the taxes on the increments above a $44,000 conversion – 28.20% on the next $1,000 converted and 30.16% on the next $5,000 converted, and 39.82% on the following $10,000 converted, although only 27.75% on the next 20,000 converted.

Once a significant change in the incremental tax % is found near a certain level – in this example between $40,000 and $50,000 – then you can focus in by trying different amounts to see exactly where the breakpoint is. In this example, it turned out to be $44,000 because any more conversions result in a much higher incremental tax percentage.

This may indicate that a conversion of $44,000 is a strategic amount of conversion, resulting in an overall tax of only 15.16% on the entire conversion. Depending on what you think your future tax rate will be, you can decide the appropriate level of conversion by picking a number that has a reasonably low true marginal tax bracket compared to your future tax bracket.

The amounts of each increment to use can be arbitrary, but should at least encompass strategic amounts determined based on the cut-off levels for various tax brackets, credit phase-outs, Medicare tax increases, AMT increase, decrease, and full phase-out levels. A thorough knowledge of the income tax system is very helpful to have when performing this analysis. Even if you don't have a great knowledge base for the tax system, using this manual method will certainly give you a better result than just going by tax brackets without taking into account all the special tax attributes or "tricks" of different levels of income.

Additional examples of how to make these calculations are in the next chapters involving Roth IRA stories.

It is interesting to see how the tax rates on each increment jump up and down and seem entirely inconsistent. To find out why this is happening, let us look at the taxes in each increment:

Roth Conversion Amount	Total Taxes, Net	Federal Ord Income Tax Included	AMT Included	State Tax, Net Included	Sched M and Other (Credits) Included	Extra 2012 Medicare Tax Included	AGI	Taxable Income
0	446	568	0	0	(122)		81,250	13,669
10,000	1,541	1,663	0	0	(122)	0	91,250	24,619
20,000	3,179	3,301	0	0	(122)	0	101,250	35,569
30,000	4,822	4,944	0	0	(122)	0	111,250	46,519
40,000	6,464	6,586	0	0	(122)	0	121,250	57,469
44,000	7,117	7,239	0	0	(122)	0	125,250	61,849
45,000	7,399	7,404	117	0	(122)	0	126,250	62,944
50,000	8,907	8,307	722	0	(122)	0	131,250	68,419
60,000	12,889	11,419	1,592	0	(122)	0	141,250	79,369
80,000	18,438	16,894	1,544	0	0	0	161,250	101,269
100,000	24,629	22,404	2,225	0	0	0	181,250	123,314
115,000	30,565	26,547	2,957	0	0	1,061	196,250	139,889
120,000	32,190	27,913	3,216	0	0	1,061	201,250	145,320
160,000	46,781	39,449	4,680	0	0	2,652	241,250	186,520
200,000	60,584	51,737	6,195	0	0	2,652	281,250	228,353
350,000	114,675	103,391	7,041	0	0	4,243	431,250	384,654
450,000	145,564	139,441	289	0	0	5,834	531,250	487,654
500,000	163,300	157,466	0	0	0	5,834	581,250	539,154
1,000,000	342,860	337,026	0	0	0	5,834	1,081,250	1,052,184

Without a Roth conversion, taxes are low and there is a Schedule M (Making Work Pay) credit of $122. You can see that through the $44,000 conversion level, they are in the

15% tax bracket and there is no AMT (alternative minimum tax). That is why the increment of $44,000 was disclosed in this analysis. After that, AMT arises and increases the incremental taxes considerably. Further complicating the issue is the tax on qualified dividends and long-term capital gains that arises after taxable income exceeds the 15% tax bracket level ($68,000 for 2010 for joint returns).

It is also interesting to note that for cases where the AMT is significant, there is usually an increment where the incremental tax rate is reduced as income rises due to the phase-out of the AMT. This can be as low as 28% on large conversion increments. In the above example, the increment is about $100,000 between a $350,000 and a $450,000 conversion. For higher income cases, this can often signal a chance to do conversions at a lower tax rate. In general, the higher the income relative to itemized deductions, the less likely the AMT is going to be a factor. Accordingly, sometimes if you are in an AMT situation without a conversion, the Roth conversion will increase your taxes, but it could also get you out of AMT—thus lowering your marginal tax rate on your Roth IRA conversion.

For higher income tax bracket readers, what is usually more important than the AMT phase-out is the potential for increases in tax rates that are expected to occur in years after 2010. No matter how large the conversion, the total tax on the conversion is usually no more than 35% for year 2010, although it could be slightly more as shown above in the incremental conversion rates due to phase-outs of deductions. The increased taxes in future years make a Roth IRA conversion in 2010 even that much more appealing for high income tax bracket readers.

Taxes if a Conversion is Not Done

As mentioned earlier, calculating the true marginal tax rate on the conversion is only one step in the process. Determining future tax rates, with and without a conversion, is another significant step. If most of the assets owned are in an IRA, converting it all to a Roth would probably be a big mistake. In future years, there would be no RMD and you would end up converting at a high rate to save taxes at a low rate. This means you probably should not convert all your IRA to a Roth. It is an easy call to say that any conversion that would result in future taxable income of less than the top of the 15% bracket is suspect. It is also suspect if the incremental conversion tax is 35% and future incremental taxes are less than 28% in the future.

There are a number of factors that should be considered when calculating future tax rates:
- You must consider the impact of the traditional IRA or retirement plan withdrawals if you don't make a conversion.
- You should also consider the impact on tax rates after a planned conversion strategy is implemented.

Furthermore, please consider some of the following issues that aren't always obvious:

- Taxable income in the future including:
    - RMD income from any unconverted IRAs
    - Social Security income and how much of it is taxable
    - Pension income
    - Other income sources
- Your future income tax deductions
- Spending needs, which may necessitate taking more than the RMD from the IRAs
- Taxable income levels of your heirs such as children and grandchildren. Even if you live a long life after the conversion, the heirs will likely end up withdrawing more than you do during your lifetime
- Future income tax rates expected
- Future marginal tax rates of the eventual surviving spouse
- Taxes in states in your current and planned future residence, if you plan to move, as well as the states of residence of the heirs. This can be a significant issue if you plan to move to or from a state such as California where IRA withdrawals and conversions would be taxed at rates that could be over 9%. Several states do not tax traditional IRA withdrawals or Roth conversions.

The key is to compare future incremental tax rates with the conversion taxes, preferably on an incremental basis. This strategy will potentially indicate the potential for a multi-year conversion strategy. For instance, in the initial example, the taxpayer may also benefit from a $44,000 conversion in 2011 as well as in 2010. A thorough analysis often results in a long-term Roth IRA conversion plan that will often involve multiple conversions over a period of years. A decision can then be made as to how much to convert in the current year with a better understanding of the tax rate advantages or costs.

Unfortunately, as we have previously discussed, there are other factors to consider besides just the comparison of the current marginal tax bracket and your future marginal tax bracket. Comparing these two brackets, however, is the starting point and probably the most important consideration in Roth IRA conversion decisions for middle-income families. The tax you pay on the conversion can be objectively calculated. The taxes to be paid on the traditional IRA or retirement plan withdrawals if a conversion is not done is a little harder to determine—but can perhaps be reasonably estimated by estimating your future income and deductions.

Perhaps equally important, or in some cases more importantly, is to consider the tax rates your heirs will have to pay in taxes on your traditional IRA. This is particularly true if you have a short life expectancy. If you were to die and leave your heirs an IRA without making a Roth IRA conversion, you should know what their tax rate might be. For example, if you are in the top tax bracket and quite old and your heirs will always be in the zero or even 10 percent bracket, making a Roth IRA conversion at a high rate to save taxes at a low rate may not make sense. Your heirs' tax rates would be useful information. In addition, you will want to know whether your heirs will take only required minimum distributions or withdraw more than that amount in determining the optimal amount to convert to a Roth IRA.

Combining Strategies into One Great Roth Launcher Process

Obviously, we are fans of using the method described in this chapter to help determine the appropriate amount for a Roth IRA conversion. For many taxpayers, we like the multiple Roth IRA conversion strategy described in Chapter Ten that we call the "Roth Launcher Strategy."