



Retirement Planning Software, Inc

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## The Roth Conversion Gamble

**W**e in the financial industry have not been very careful, for the most part, about how we recommend whether Roth conversions be made or not. But now that such conversions are available to truly affluent people, where both the amounts at stake and the financial and legal sophistication of the clients may be greater, perhaps it's a good time to rethink our approach.

This re-evaluation is overdue, because the traditional approach completely mistakes the nature of the problem. The mathematics may be right, but we have been modeling only the technicality of the rules while ignoring the environment in which they operate. The environment, to put it bluntly, is a casino, and the decision itself is fundamentally a gambling proposition.

There are four things that determine whether a Roth conversion is a good idea or not:

1. Whether and how Congress will change the Internal Revenue Code in the future.
2. Whether state taxes will change, either because of revisions in state tax laws or because of relocation to another state.
3. The total amount of taxable income, during the conversion vs. the future.
4. Everything else (impact of required minimum distributions, impact on heirs, etc.).

Of these, the latter two can be hard to predict, but the first two are virtually impossible to predict. They are, all but literally, a spin of the roulette wheel.

### What's your future marginal tax rate?

**T**his question is a staple of Roth calculators. When clients or advisors punch this one number into a Roth calculator, they are usually determining what the recommendation will be: *if the future marginal tax rate is higher than the current rate, a Roth conversion will almost always be recommended* – and if not, then it won't be.

But unless you can correctly answer the first three questions above, you can't make even a good guess at the future marginal tax rate (or rates, since this could change a lot from year to year). Given that top federal marginal tax rates during the lifetime of some of us have ranged as high as 90%, a best guess could be off not just by two or three percentage points, but by a *factor* of two or three!

It's easy to argue that income tax rates have to increase, maybe dramatically, in the coming years and decades. We have huge budget deficits at both the federal and the state levels, while we face the challenge of pumping new funds into Social Security and Medicare as well as addressing enormous challenges in our national infrastructure, health care, global competitiveness, and many other areas. Meanwhile, the ratio of working people to non-working people (too young or too old) will continue to decline for the next twenty years or so. We are going to have to raise income tax rates.

Or are we? Will we instead go further and further into debt, cut benefits and services, reduce military spending, and/or push more responsibility for the social good onto private charity? Or will we tap sources of revenue other than income taxes? There is no shortage of plans to revamp the tax code. A value-added tax, or a revenue-neutral flat tax, for example, could drastically reduce the marginal rates found today in the upper brackets.

It doesn't matter whether you favor such changes or not. What matters is that tax rates could either rise or fall greatly over the next forty, twenty, ten, or even five years. Or they might stay essentially the same as today. None of us can be at all confident what is going to happen.

To the extent that Roth conversions are a bet on current vs. future marginal tax rates, therefore, it is about as close as we get in real life to a pure gamble.

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## What's your taxable income?

**P**redicting taxable income is *not* a pure gamble, but making a plausible guess takes a lot of analysis. And as long as we have a graduated tax system, as we have in the Federal code and in most states, the marginal tax rate in any given year depends on the amount of taxable income.

Estimating future taxable income is hardest when retirement is still to come. Regular paychecks usually end in retirement (but not always, and not always completely), and other forms of taxable income come into play: pensions (fully taxable), Social Security (at least partly taxable), perhaps some earned income (from oneself, or maybe a spouse who has not yet retired – taxable), possibly some deferred compensation (taxable), and investment income (usually at least partly taxable at ordinary income tax rates).

Projecting these amounts several years ahead is tricky, and projecting them decades ahead is real guesswork in the absence of a sophisticated analytical model. Such a model is probably overkill for Roth analysis *alone*, though. And I say this even though our company has developed and offers such a model. Data is needed on a broad array of questions about assets and income that are obviously necessary to estimate future taxes. Less obviously, details about expenses and debts (and other factors, such as government and employee benefits, and insurance coverages) also need to be provided, to identify whether asset balances are going up or down, and therefore whether taxable investment income, or taxable withdrawals from qualified plans, are changing over time.

Our model shows that in many households, while taxable income drops dramatically at retirement, it often increases from that low point. In affluent households, this happens because expenses do not nearly eat up the annual income, and so investment balances grow and taxable income rises. In non-affluent households that are spending down their assets, taxes might stay low for a while in early retirement as taxable assets get used up first, but then taxes begin to increase as tax-deferred assets are tapped. And sometimes taxable income from those assets increases the taxability of Social Security benefits.

These general observations do not necessarily apply in any specific case, however, and radical changes can occur. Some are highly predictable, some partially predictable, and some are highly unpredictable.



These general observations may not apply in any given case, however, and many other more radical changes can occur – some of which are highly predictable, some partially predictable, and some highly unpredictable.

A mortgage pay-off, for example, is highly predictable – the exact date and amount are known far in

advance. But the effects are less predictable. If the family has been using IRA withdrawals to cover the mortgage, taxable income will plummet once the mortgage is gone.

Somewhat predictably (with a good enough model), the sale of a house may be necessary because there are not enough other assets and income to support the family indefinitely. This sale could free up a few hundred thousand dollars even in an average middle class family, and it could generate enough taxable income to push them one or even two tax brackets higher.

So might an inheritance, or investment income generated from insurance death benefits. Conversely, the death of one spouse might reduce pension and Social Security benefits enough to drop the surviving spouse into a lower bracket.

Such examples are easily multiplied. The main point, though, is that even if the tax structure itself were predictable, where an individual or couple will fall within that tax structure years or decades from now would still remain something of a gamble.

## A rational gambling strategy

**I**n an environment dominated by as much uncertainty as the Roth decision, the rational approach is to hedge one's bet. Since one is forced to play the game – because doing nothing is, in itself, a gamble – one should place some chips on both red and black, not all one, and not all the other. This split option is particularly well suited to the Roth gamble because of the way it plays out in practice.

As noted above, one's tax situation changes over time, and can even shift dramatically from year to year. In years when one is in a lower than typical bracket, it makes sense to withdraw funds from a traditional tax-deferred account, and pay the taxes at a low rate. In years when the tax bracket is higher, it's better to withdraw from a Roth account.

Even if the tax bracket does not change over time, having both kinds of funds is beneficial. Taxable funds can be withdrawn from a traditional account up to the point where further withdrawals thrust one into the next tax bracket, and Roth funds can be used above that point.

But while it is one thing to recommend that it's smart to have tax-advantaged funds split between these two types, it is another to know whether the split should be 50-50, or heavily weighted in one direction.

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## The best place to gamble? How about Monte Carlo?

Monte Carlo models have enjoyed an undeserved vogue in retirement planning lately, but the Roth decision is actually a good application for this technique. Although it cannot evaluate risk in anything resembling the accurate fashion it so often gets credit for, it does provide a rational basis for estimating a split between traditional and Roth accounts.

The Monte Carlo technique, as is fairly well known by now, involves using randomized rather than fixed assumptions, and performs a large number of randomized calculations to estimate the odds of ultimate success or failure.

As applied to the Roth problem, the Monte Carlo approach could work like this: Most of the numerical inputs and underlying assumptions – particularly those affecting future tax brackets – would be randomized and tested in multiple trials. If the Roth arrangement worked better in, say, 65% of these trials, we could justifiably recommend that the client ultimately seek to convert 65% of tax-deferred funds to a Roth account.

This is far from a perfect approach. The Monte Carlo method cannot actually predict the future, and its results are unlikely to prove optimal, except in individual cases by dumb luck. ***But it is far less likely than currently used methods to recommend a strategy that proves to be completely wrong.*** As a way to hedge the bet, it's a highly rational strategy much better suited to the problem than what is being used today.

Due to the renewed interest in Roth calculations in 2010, we are updating an experimental model we had developed some time ago for desktop use, and moving it to the internet. (This is not the sophisticated cash flow model mentioned above, but an easier to use calculator specific to the Roth decision.) If this approach appeals to you and you would like to discuss it, let us know; perhaps we can take your ideas and preferences into account.

Still River Retirement Planning Software, Inc. provides both web-based and desktop software offering specialized calculations related to retirement plans and retirement planning.

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