The Mathematics of Proactive IRA Tax Planning After the Secure Act

How to Plan Now That Stretch Benefits Are Eliminated

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How to Plan Now That Stretch Benefits Are Eliminated

Presented by Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished)[1]

Keebler & Associates, LLP

Robert.keebler@keeblerandassociates.com

1. Special thanks to Stephen J Bigge, CPA for his assistance with modeling alternative strategies

Outline

- 2019 Law and Secure Act Changes

- Conduit Trust Disaster – The Math

- New Post-mortem Payout Rules

- Roths vs. Traditional IRAs

- Solutions to Analyze

  - Roth conversions

  - Multi-generational spray trusts

  - Spousal rollovers and the *new* spousal rollover trap

  - IRAs to CRTs

  - IRA trusts for state income tax savings

  - IRA relocation to life insurance

  - Life insurance to offset increased tax-risk of early death

  - Naming a charity as a beneficiary

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Pre-Secure Law

Required Minimum Distributions

- RMD's Started at 70 ½ **(pre-SECURE ACT)**

Stretch Out IRAs
"Inherited" IRA

IRA's were allowed to be stretched over an inheritors lifespan **(pre-SECURE ACT)**

Objective: Prolong IRA payments over longest possible period of time, thus increasing wealth to future generations

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SECURE BILL
KEY CHANGES

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RMDs

<u>Now Start at age 72</u>

New RMD after Death

Basically, requires all IRAs, Roth IRAS, and Qualified Plans to be distributed within 10-years of death

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RMDs after Death

Exceptions from the 10-year Rule for certain beneficiaries ("eligible designated beneficiary")

- – Surviving Spouse
- – The employee's Children under the age of majority *(not grandchildren or any other children)*
- – Disabled
- – Chronically ill
- – Individual not more than ten years younger than employee

§§ 401(a)(2)(E)(ii)

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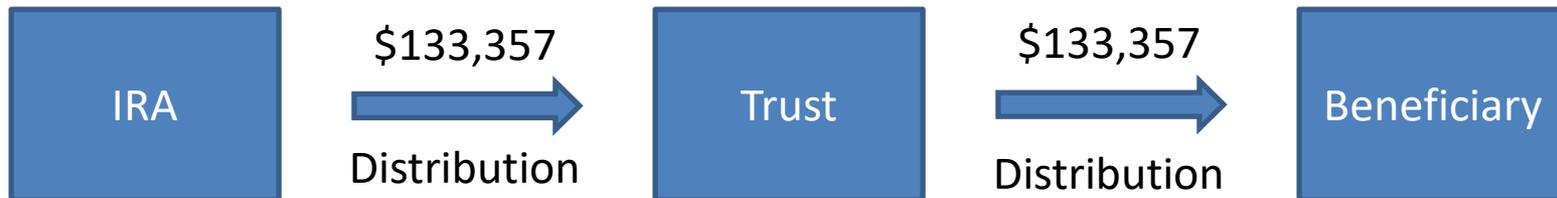
Secure Act Beneficiary RMD Summary

Tax Terminology	Designated Non-Eligible Beneficiary	Surviving Spouse	Eligible Minor Child	Person Less Than 10 Years Younger	Disabled or Chronically Ill Person
Outright Beneficiary	10-Year Rule	Life Expectancy Rule	Life Expectancy Rule (Until Majority then 10-Year Rule)	Life Expectancy Rule	Life Expectancy Rule
Conduit Trust	10-Year Rule	Life Expectancy Rule	Life Expectancy Rule (Until Majority then 10-Year Rule)	Life Expectancy Rule	Life Expectancy Rule
Designated Beneficiary Trust	10-Year Rule	10-Year Rule	10-Year Rule	10-Year Rule	Life Expectancy Rule
Non-Designated Beneficiary Trust	Before RBD: 5-Year Rule	Before RBD: 5-Year Rule	Before RBD: 5-Year Rule	Before RBD: 5-Year Rule	Before RBD: 5-Year Rule
	After RBD: Ghost Life Expectancy Rule	After RBD: Ghost Life Expectancy Rule	After RBD: Ghost Life Expectancy Rule	After RBD: Ghost Life Expectancy Rule	After RBD: Ghost Life Expectancy Rule

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Trusts for Disabled and Chronically Ill Beneficiaries

- Life Expectancy Treatment is Available with a "Eligible Designated Beneficiary Trust"

- Need to Draft an Accumulation Trust

- Roth IRAs may work better due to:

  - The difference in the individual and trust tax rates

  - The ability to pay the income tax on conversion out of nonqualified funds

- Two trusts is advisable if the client has both a traditional IRA and a Roth IRA – this avoids "trapping" the taxable IRA income

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Math of the Conduit Trust Disaster

- A conduit ("safe–haven") trust requires all RMDs to be paid annually

- This worked well under the life expectancy rules

- However, it is a disaster under the 10-year rule

- In year ten, the entire remaining IRA balance must be paid to the beneficiary

| IRA | $133,357 Distribution → | Trust | $133,357 Distribution → | Beneficiary |

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The Conduit Trust Disaster

Illustrated

| Years after | | RMD | 10-Year Rule Options | |
Death	Age	Current Method	Equal Schedule	Full Deferral
0	30	$18,762	$133,357	$0
1	31	$20,100	$133,357	$0
2	32	$21,535	$133,357	$0
3	33	$23,072	$133,357	$0
4	34	$24,720	$133,357	$0
5	35	$26,486	$133,357	$0
6	36	$28,379	$133,357	$0
7	37	$30,409	$133,357	$0
8	38	$32,584	$133,357	$0
9	39	$34,917	$133,357	$0
10	40	$37,417	$133,357	$2,104,852

Assumes $1,000,000 IRA at death & a 7% interest rate

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Ten Year Rule - Roth vs. Traditional IRA

- If minimizing income taxation is the only concern, Roth distributions after death should generally be deferred until the end of the Ten-Year period – *"The Roth Reprieve"*

- Traditional IRA distributions will be tactically withdrawn to manage income tax rates

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Tax-Driven Beneficiary Designations

- Utilize Spousal Rollovers

- Utilize Exception Beneficiaries

- Avoid the application of the Five-Year Rule with an outright beneficiary or a Designated Beneficiary Trust

- Consider forcing the Ghost Life Expectancy Rule to apply for clients aged 72 to 81

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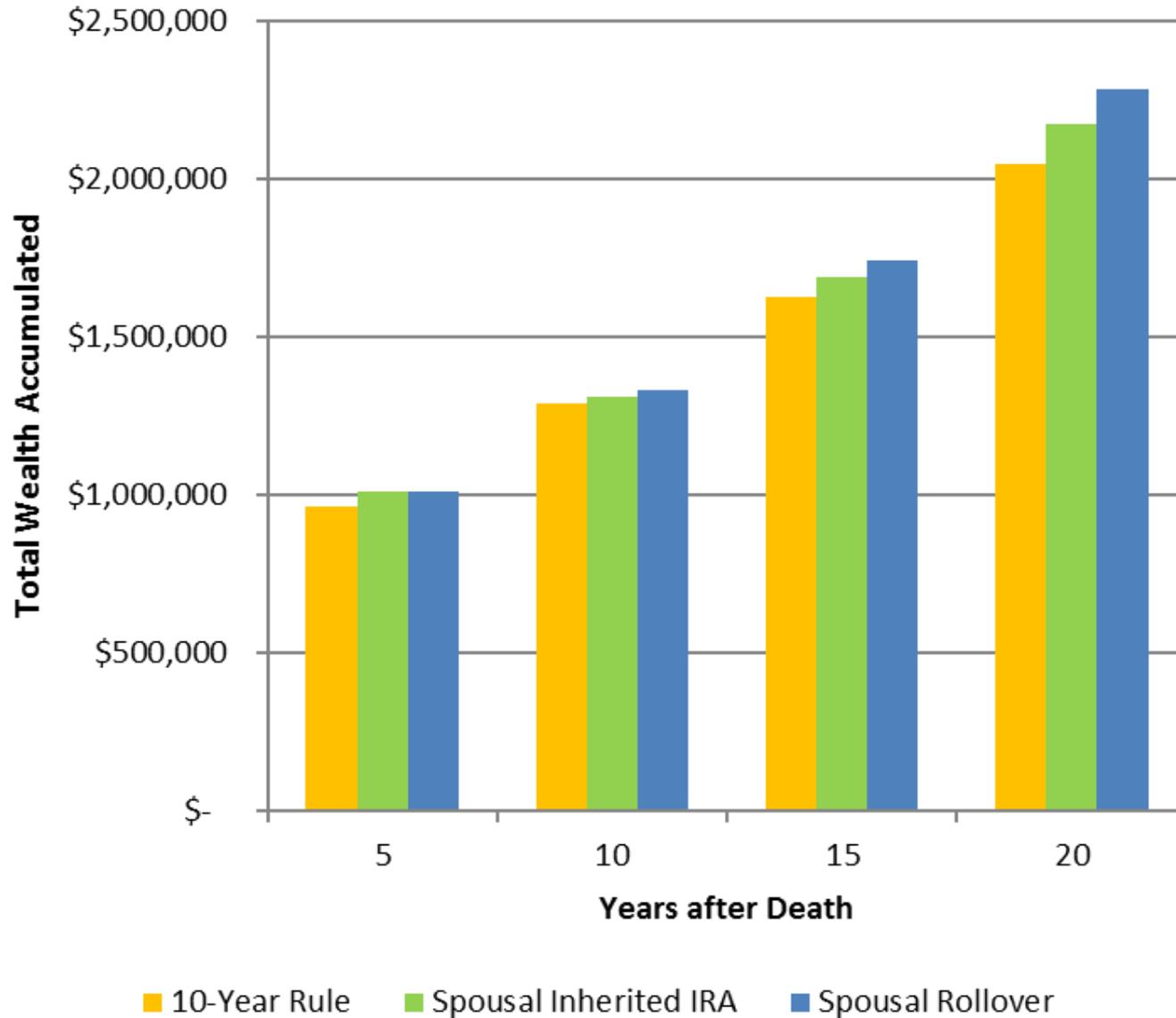
Tax-Driven Beneficiary Designations

- Examples – Universal Assumptions:
  - 6% pre-tax return
  - 5% after-tax return; very conservative difference
  - Distributions are subject to a 25% average tax rate – held constant to avoid confusion regarding the changes provided by the new law

Tax-Driven Beneficiary Designations

Spouse as Beneficiary

- <u>Example 1</u>:

  - Consider a 76-year-old surviving spouse who expects to live to age 85

  - What is the value of capturing the Spousal Rollover for a $1,000,000 IRA?

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Tax-Driven Beneficiary Designations

Tax-Driven Beneficiary Designations

- <u>Example 6-2</u>:
  - Now consider a similarly situated client who is age 87.
  - Does the an non-qualified designated beneficiary named still make sense?
  - Assume 6% pre-tax return and a 5% after-tax return
  - Assume the distributions are subject to a 25% average tax rate

Tax-Driven Beneficiary Designations

IRA PLANNING SOLUTIONS TO ANALYZE

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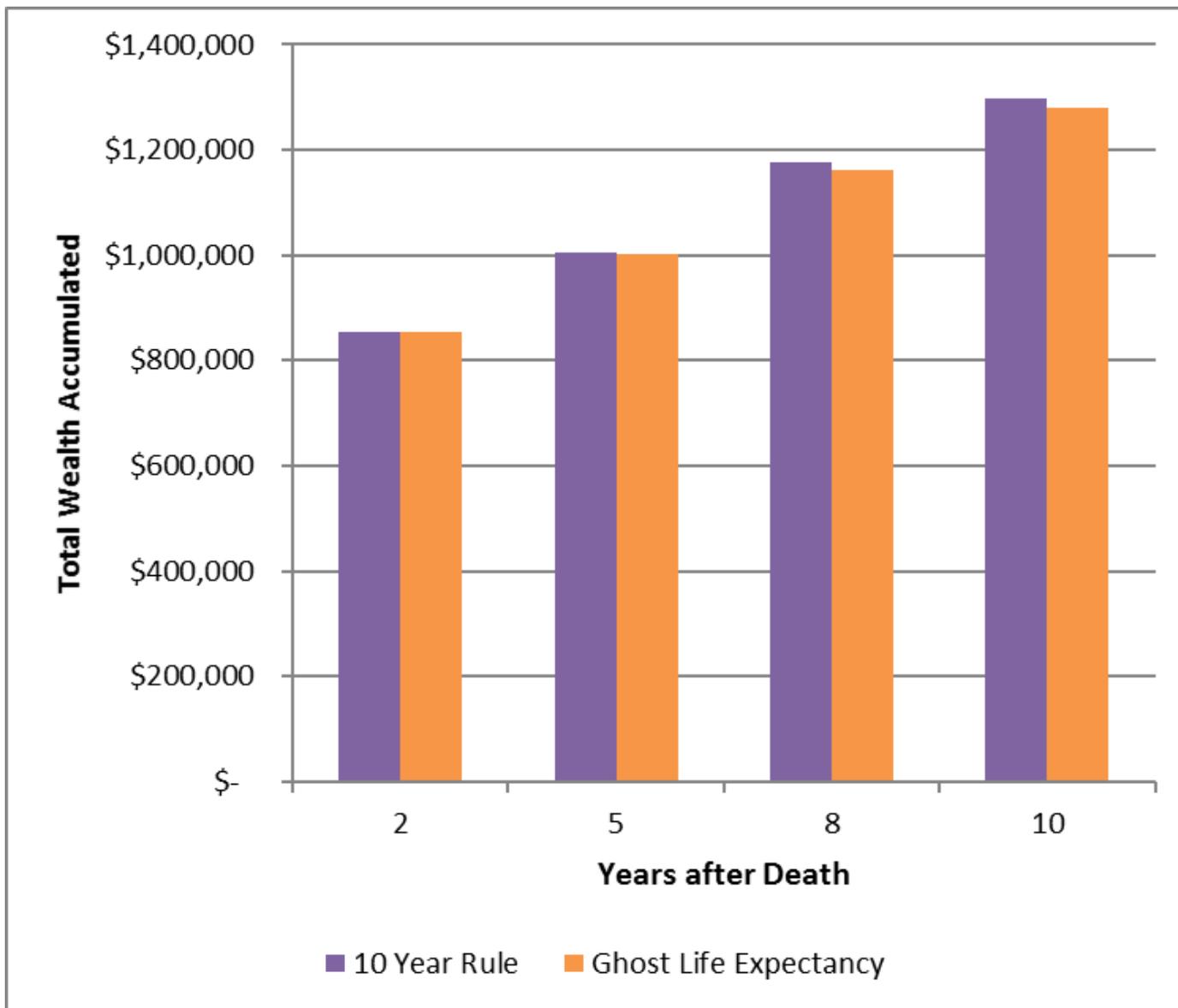
IRA Planning Solutions to Analyze
Overview

- Roth conversions

- Designated Beneficiary - multi-generational spray trusts

- Spousal rollovers and the *new* spousal rollover trap

- IRAs to CRTs

- IRA trusts for state income tax savings

- IRA relocation to life insurance

- Life insurance to offset increased tax-risk of early death

- Naming a charity as a beneficiary

- Avoiding the Five-Year Rule

- Avoiding or using the "Ghost Rule"

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Secure Act Protocol FLOWCHART

Does the Client Wish to Enhance Wealth Transfer?

Yes

Is the Client Charitably Inclined?

Yes → Explore CRT or Direct Charity Gifts

No

Explore Insurance Options

Explore Roth Conversion Options

Explore Eligible Beneficiaries
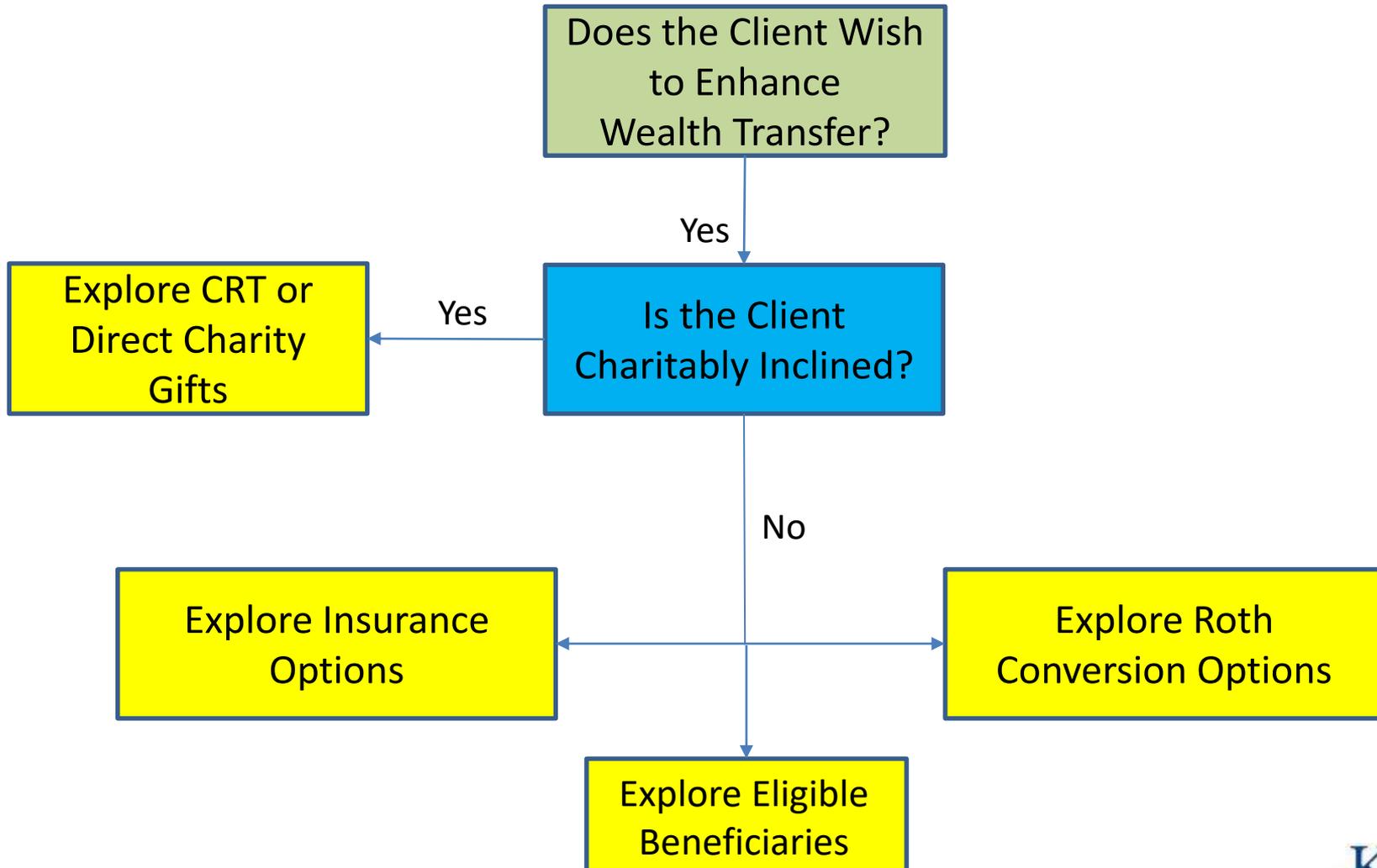
Solutions After the Secure Act

Spousal Rollover Strategies

A. Traditional IRA to Spouse – 100% Rollover

B. Traditional IRA to Spouse – X% Disclaimer
   - 1.) Result: Deferral until RBD followed by 10-year payout.
   - 2.) Result: Children begin a 10-year payout followed by an additional 10 years at the second death

Roth Conversions

A. Lifetime Conversions by Plan Owner

B. Death-Time Conversions by Plan Owner's Family

C. Spousal Rollover Followed by a Roth Conversion

Charitable Remainder Trusts

A. Death-Time Payment to CRT – Spouse

B. Death-Time Payment to CRT - Children

Life Insurance "Relocation"

A. Acquire Life Insurance, in ILIT, on Plan Owner

B. Acquire Life Insurance, in ILIT, on Spouse

C. Acquire Life Insurance, in ILIT, Second-to-Die

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THE NEW SPOUSAL ROLLOVER TRAP

Old Best Practice

| Deceased Spouse | → Spousal Rollover → | Surviving Spouse | → "Inherited" IRA → | Children |
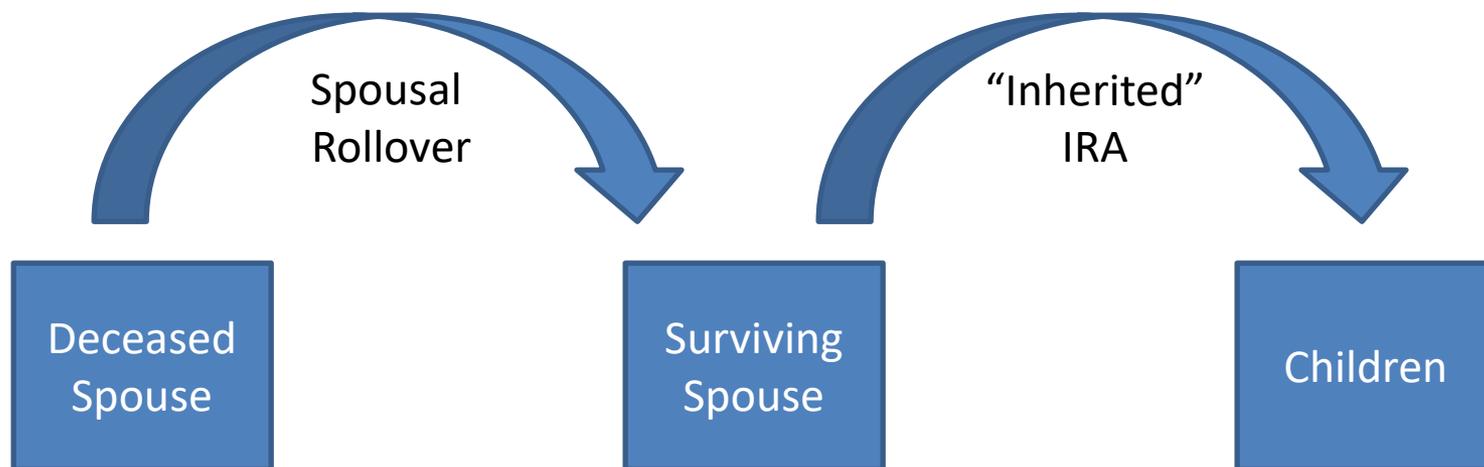
IRC § 408

THE NEW SPOUSAL ROLLOVER TRAP
Old Best Practice &
the New Spousal Rollover Trap

10-Year Rule Distributions

Lifetime RMDs

First Death

8 Years ?

Second Death

10 Years

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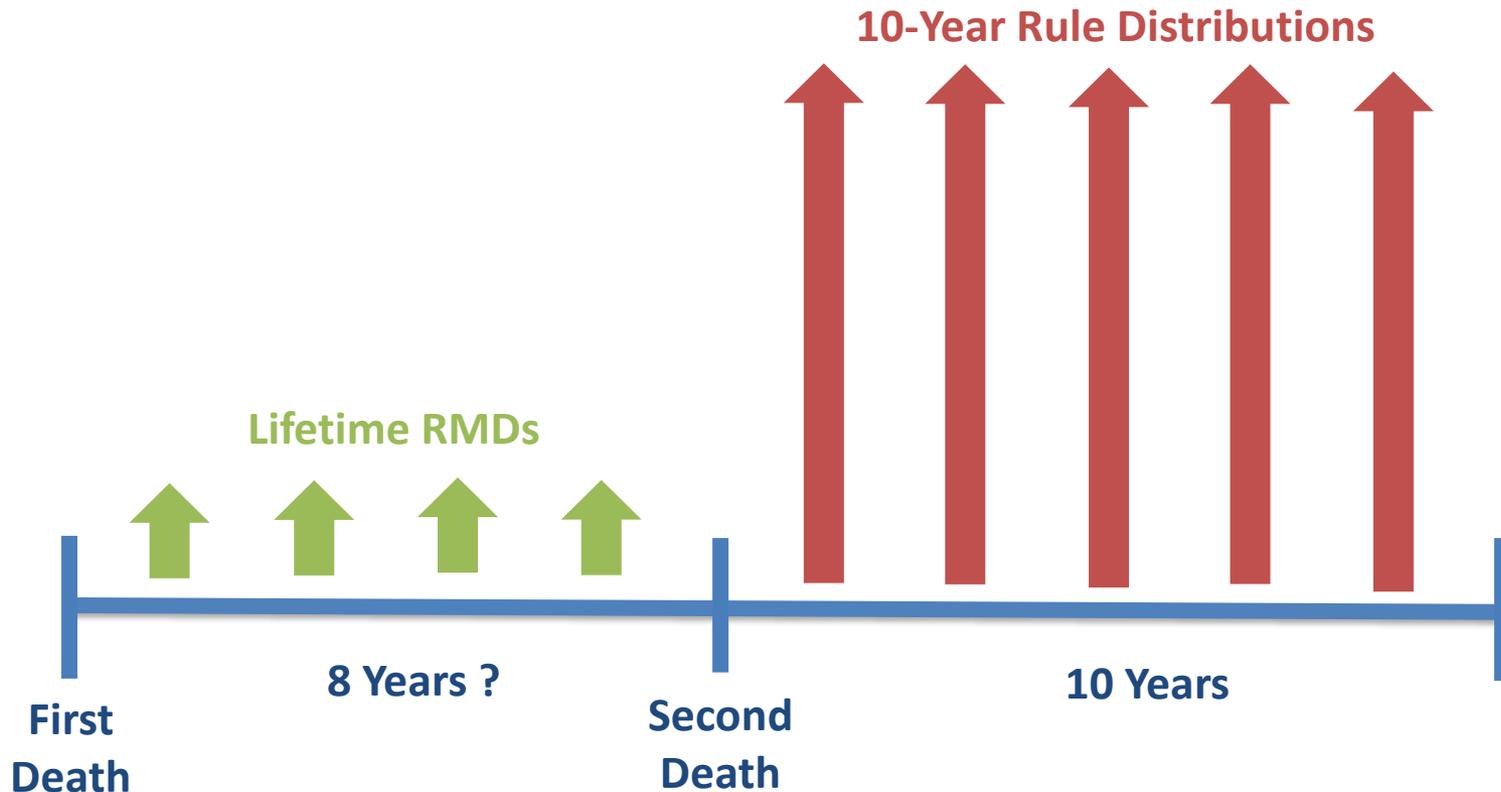
THE NEW SPOUSAL ROLLOVER TRAP

Potential New Best Practice
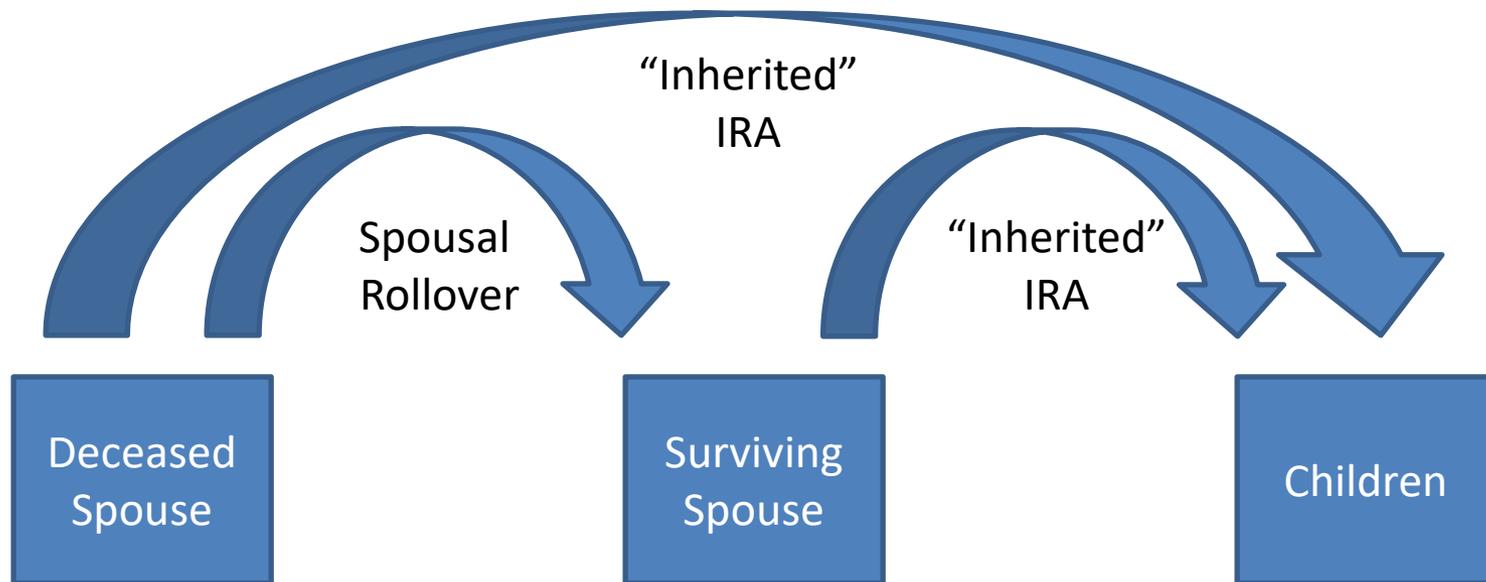
THE NEW SPOUSAL ROLLOVER TRAP

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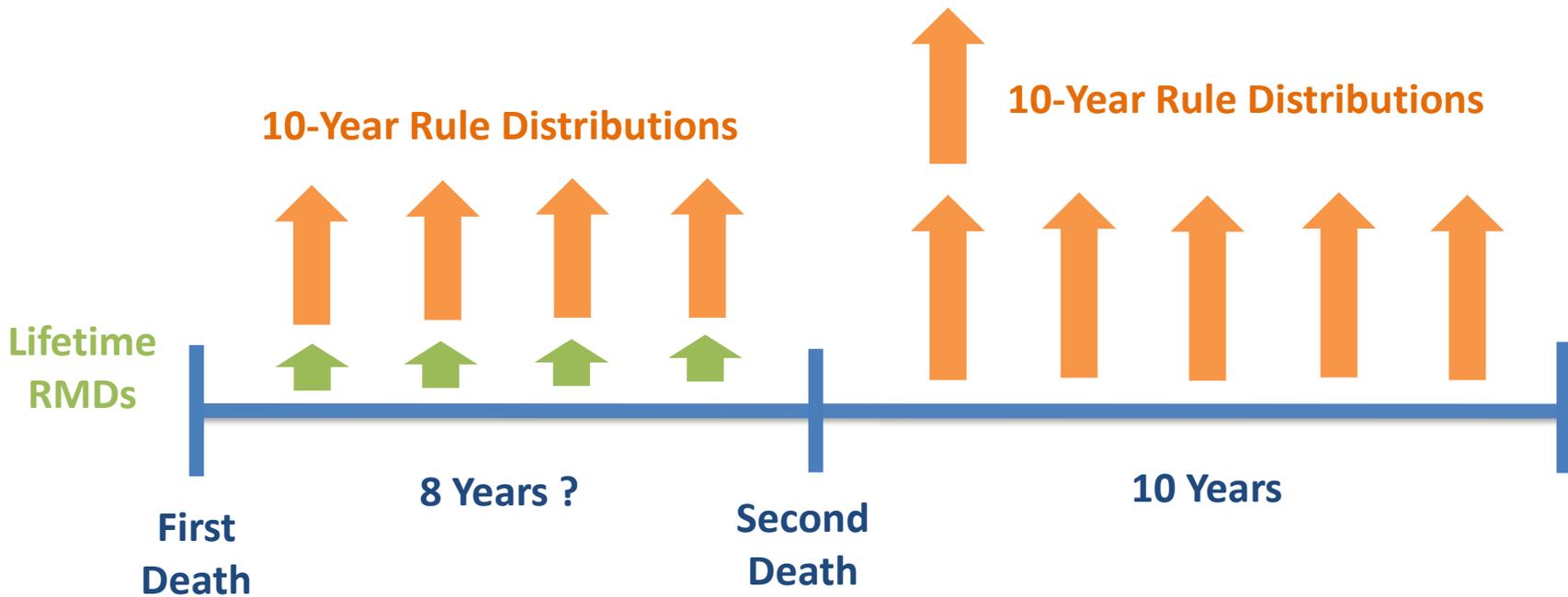
ROTH CONVERSIONS

As it relates to the new 10-year rule, the purpose of Roth Conversions is to spread distributions over many years and lower brackets

2020 Tax Brackets
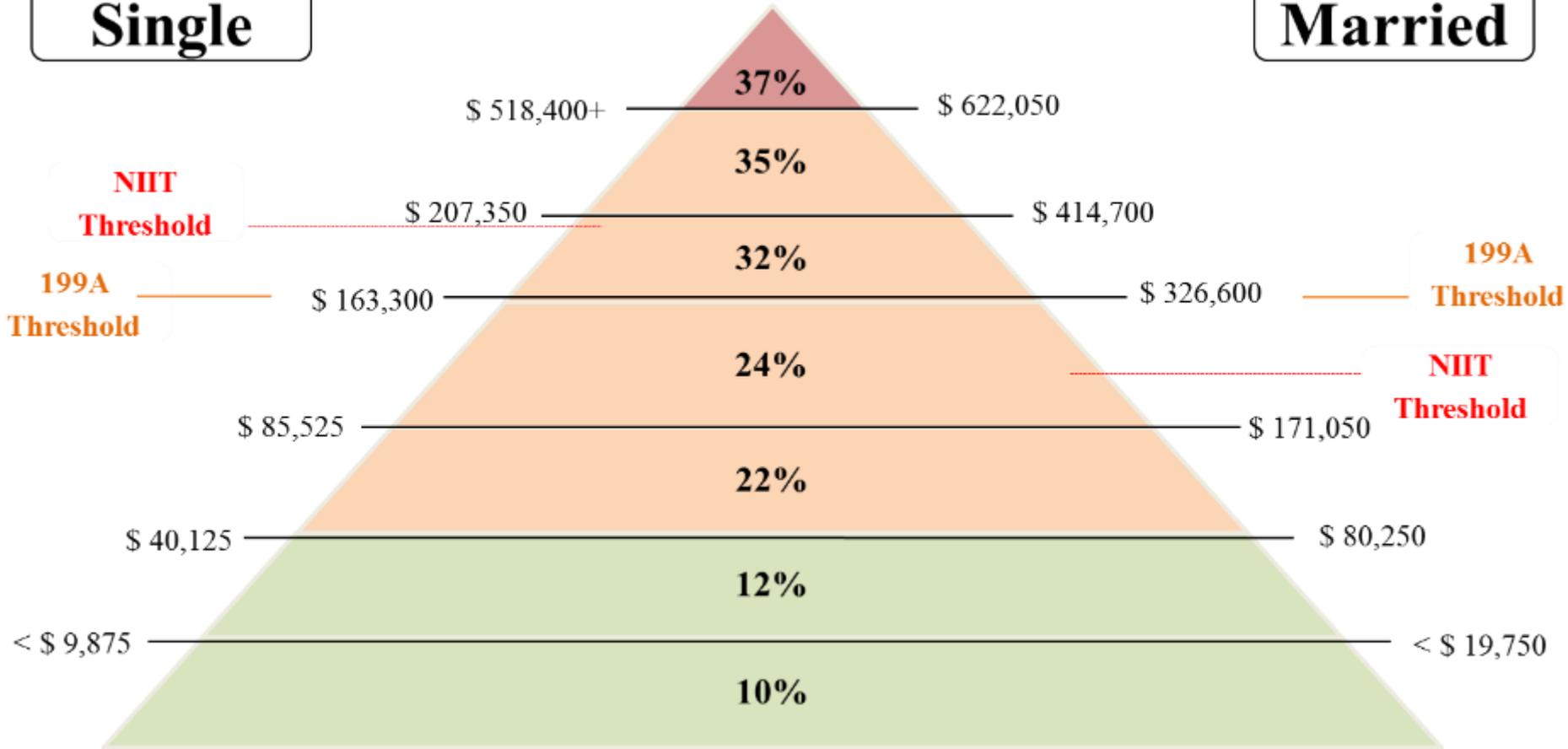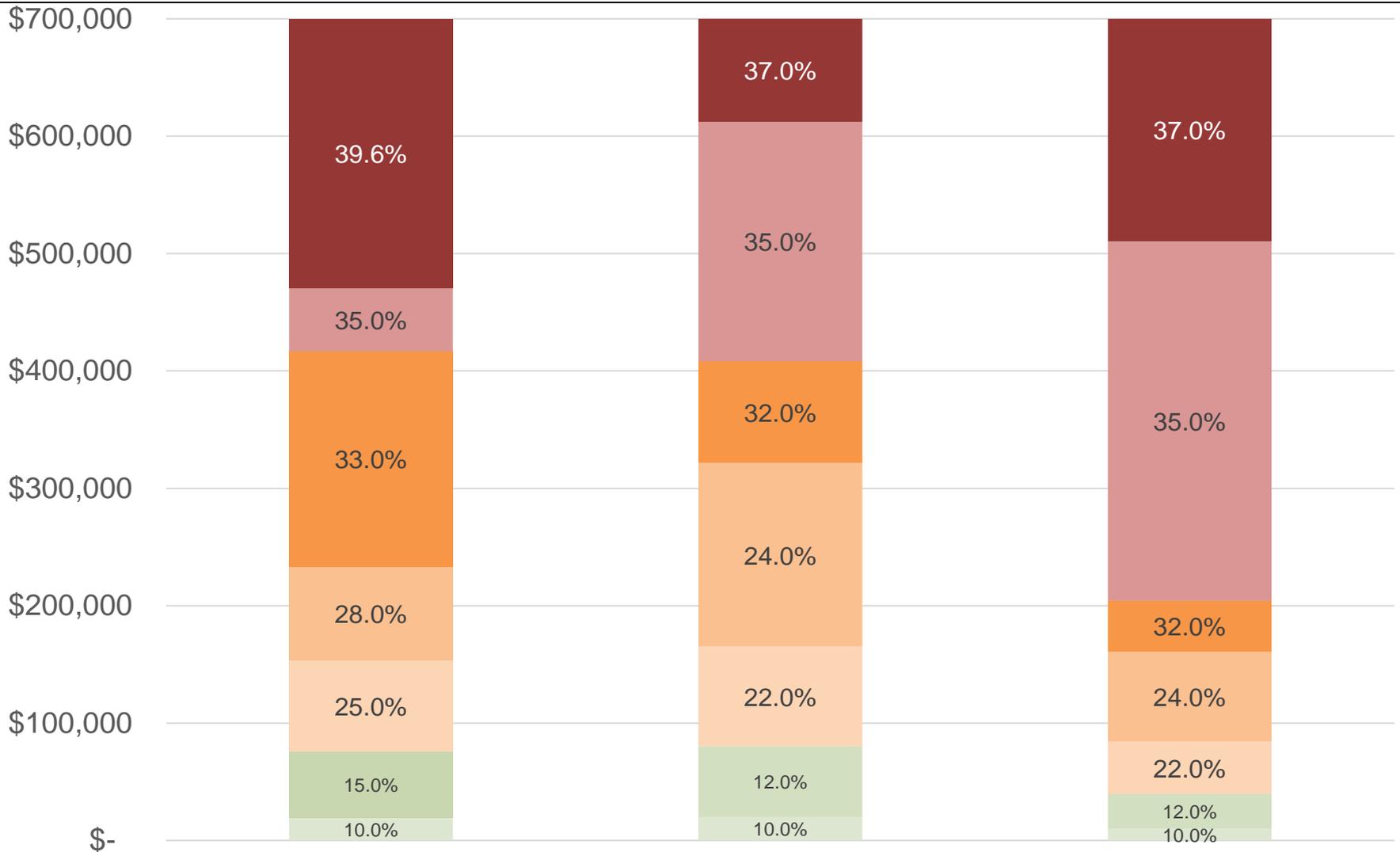
Taxation of Roth IRA Distributions

	Distribution within 5 years	Distribution beyond 5 years
Age < 59½	Income Tax: Yes (earnings only) 10% Penalty: Yes (earnings & taxable portion of prior conversion amounts)	Income Tax: Yes (earnings only) 10% Penalty: Yes (earnings only)
Age ≥ 59½	Income Tax: Yes (earnings only) 10% Penalty: No	Income Tax: No 10% Penalty: No

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Mathematics of Roth IRA Conversions

- In simplest terms, a traditional IRA will produce the same after-tax result as a Roth IRA provided that:
  - The annual growth rates are the same
  - The tax rate in the conversion year is the same as the tax rate during the withdrawal years (i.e. A x B x C = D; A x C x B = D)

Mathematics of Roth IRA Conversions

	Traditional IRA	Roth IRA	Life Insurance
Current Account Balance	$ 1,000,000	$ 1,000,000	$ 1,000,000
Less: Income Taxes @ 40%	-	(400,000)	(400,000)
Net Balance	**$ 1,000,000**	**$ 600,000**	**$ 600,000**
Growth Until Death	300.00%	300.00%	300.00%
Account Balance @ Death	$ 3,000,000	$ 1,800,000	$ 1,800,000
Less: Income Taxes @ 40%	(1,200,000)	-	-
Net Account Balance to Family	**$ 1,800,000**	**$ 1,800,000**	**$ 1,800,000**

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Mathematics of Roth IRA Conversions

- Critical decision factors
  - Tax rate differential (year of conversion vs. withdrawal years)
  - Use of "outside funds" to pay the income tax liability
  - Need for IRA funds to meet annual living expenses
  - No RMDs
  - Tax-free post-mortem distributions
  - Time horizon
  - Estate tax considerations
  - Ten Year "Roth Coast" period

Mathematics of Roth IRA Conversions

Deferral
Beyond
the RBD

Using Outside Funds
to Pay Conversion Tax

Tax Rate Arbitrage

10-Year Post-mortem Tax-free Growth
"Roth Coast Period"

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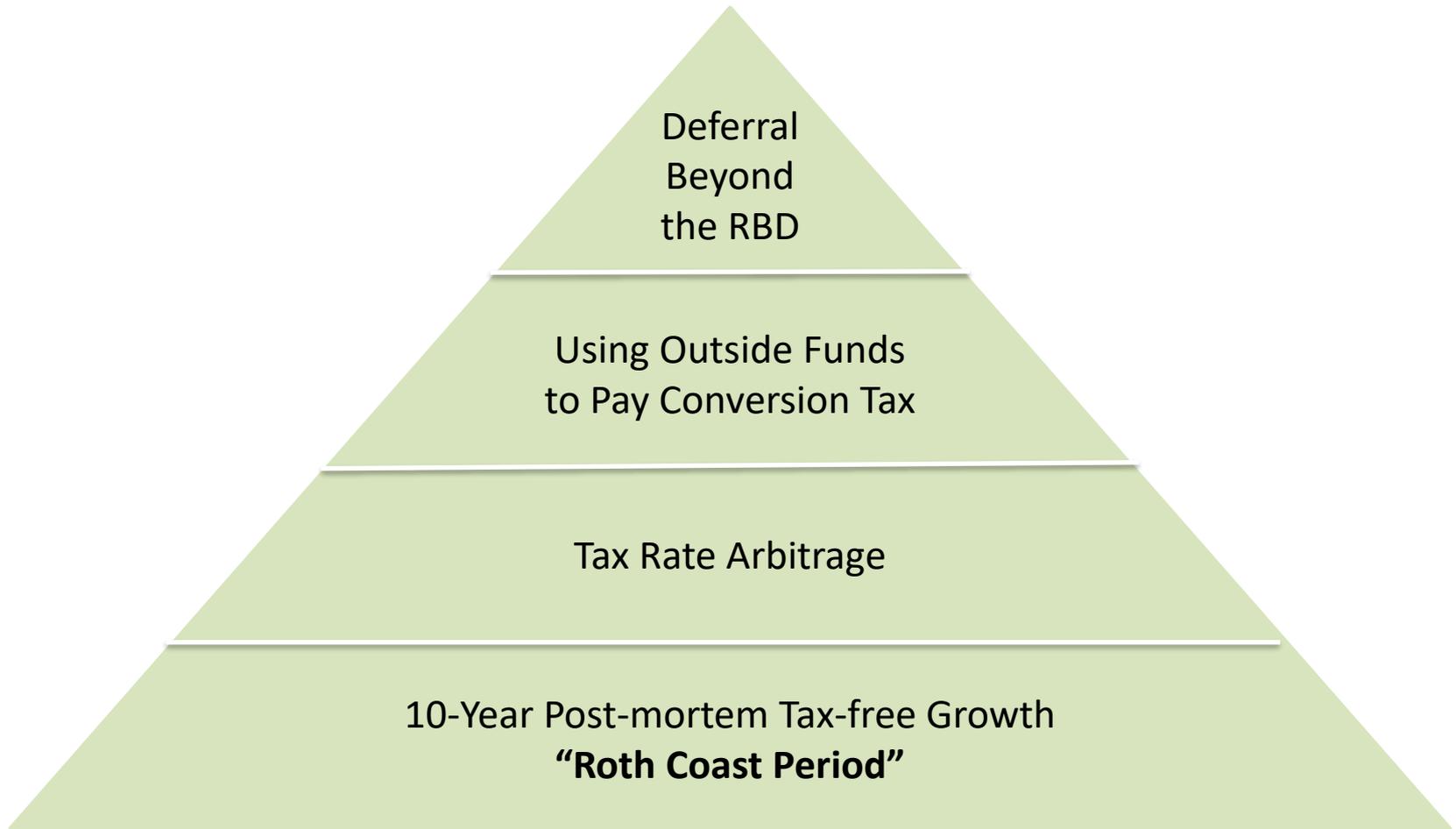
Mathematics of Roth IRA Conversions

- The key to successful Roth IRA conversions is usually to avoid large jumps in brackets (e.g. converting at a 32% when distributions will likely be subject to a 24% rate will often be ineffective)

- Although brackets are the primary consideration, there are others: capital gains, AMT, NIIT, 199A, etc.

Mathematics of Roth IRA Conversions

Example of a possible "optimum" conversion amount

37% tax bracket

35% tax bracket

32% tax bracket

Current taxable income

24% tax bracket

22% tax bracket

12% tax bracket

10% tax bracket

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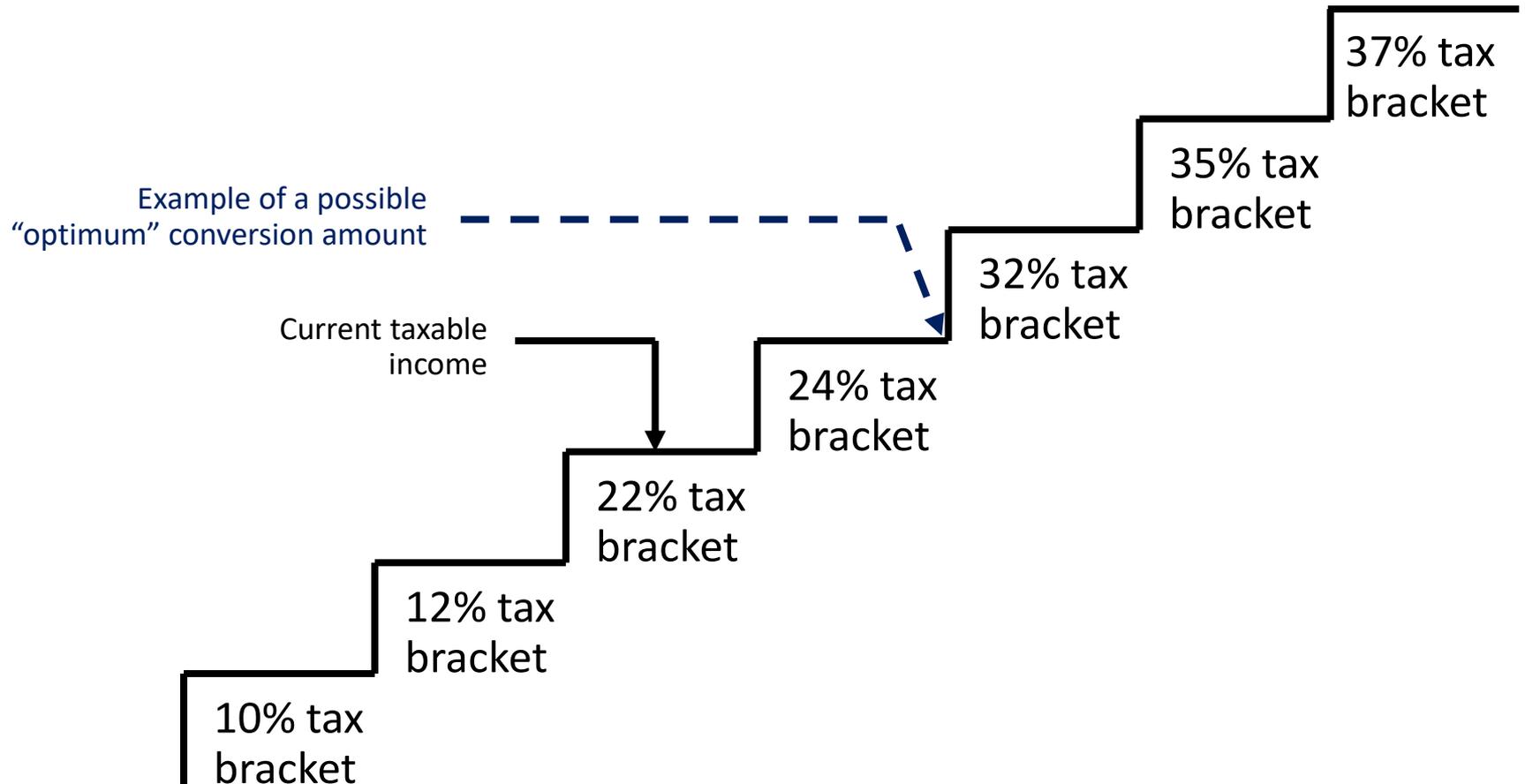
Mathematics of Roth IRA Conversions

Target Roth IRA conversion range for most "middle income" taxpayers

39.6% tax bracket

35% tax bracket

37% tax bracket

33% tax bracket

35% tax bracket

28% tax bracket

32% tax bracket

25% tax bracket

24% tax bracket

15% tax bracket

22% tax bracket

10% tax bracket

12% tax bracket

10% tax bracket
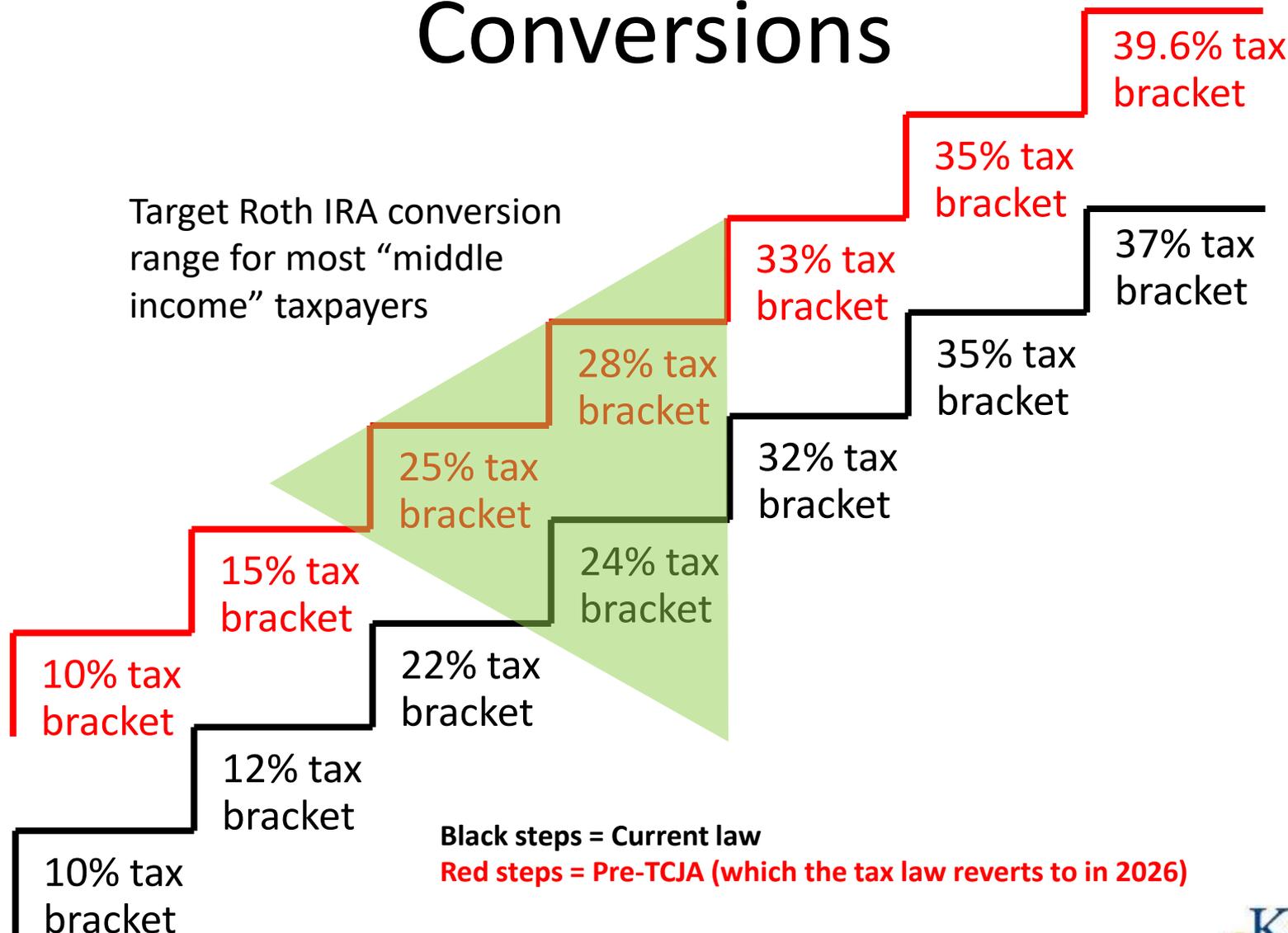
Black steps = Current law

Red steps = Pre-TCJA (which the tax law reverts to in 2026)

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Mathematics of Roth IRA Conversions

- Tactical considerations
  - Unused charitable contribution carryovers
  - Current year ordinary losses
  - Net Operating Loss (NOL) carryovers
  - Alternative Minimum Tax (AMT) credits
  - Other credit carryovers

MULTI-GENERATION SPRAY TRUST

As it relates to the new 10-year rule, the purpose of using a spray trust is to spread income across a large number of taxpayers thereby lowering the effective rate and to retain the ability to accumulate income as prudent

WARNING: Don't forget about the "kiddie" tax

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Foundational Concepts
General Trust Tax Rules

- Income taxed to either the trust or the beneficiaries
  - If income is accumulated, then the income is taxed to the trust/estate
  - If income is distributed, then the trust/estate gets an income tax deduction and beneficiaries report taxable income
  - IRC § §(661-663)

Consider how Roth's are taxed

Foundational Concepts
2020 Ordinary Income Tax Rates for Estates & Trusts

37%

$ 12,950

35%

$ 9,450

24%

$ 2,600

10%
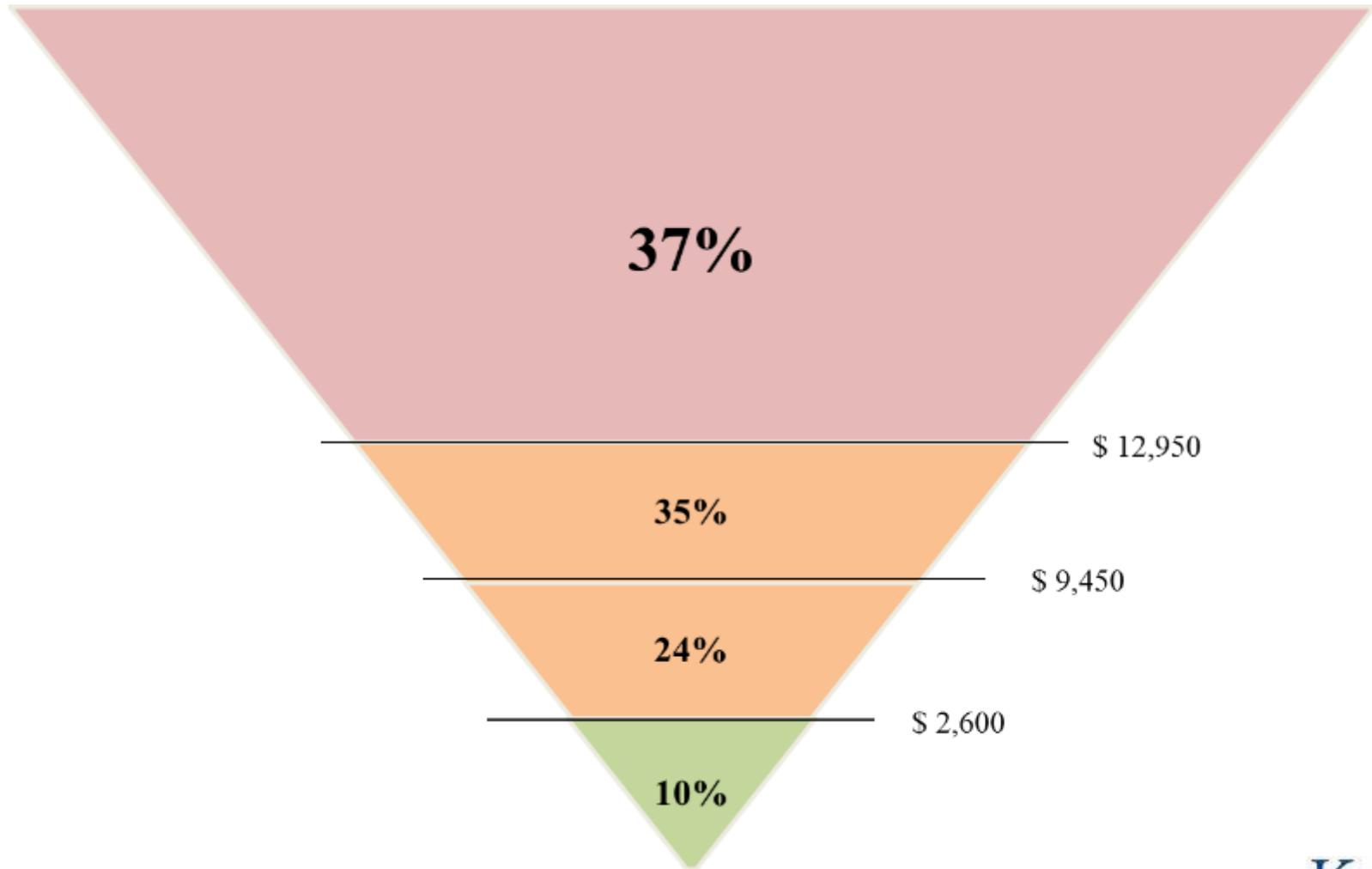
Charitable Remainder Trusts
Overview

- Charitable Remainder Trust (CRT)

Annual (or more frequent) payments for life (or a term of years)

Donor → IRA → **CRT** → **Child** (Income Beneficiary)

Donor receives an immediate income tax deduction for present value of the remainder interest (must be at least 10% of the value of the assets originally contributed)

At the end of the trust term, the charity receives the residual assets

Charity (Remainder Beneficiary)

Warning: Charitable Intent Required

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Secure Act
Life Insurance Strategies

Life Insurance

- Four Strategies
  - IRA Roth Conversion Hedge
  - IRA Relocation
    - Policy on Owner
    - Policy on Spouse
    - Second-to-die policy
  - Income Tax Replacement
  - Roth Conversion Subsequent to Owner's Death by spouse
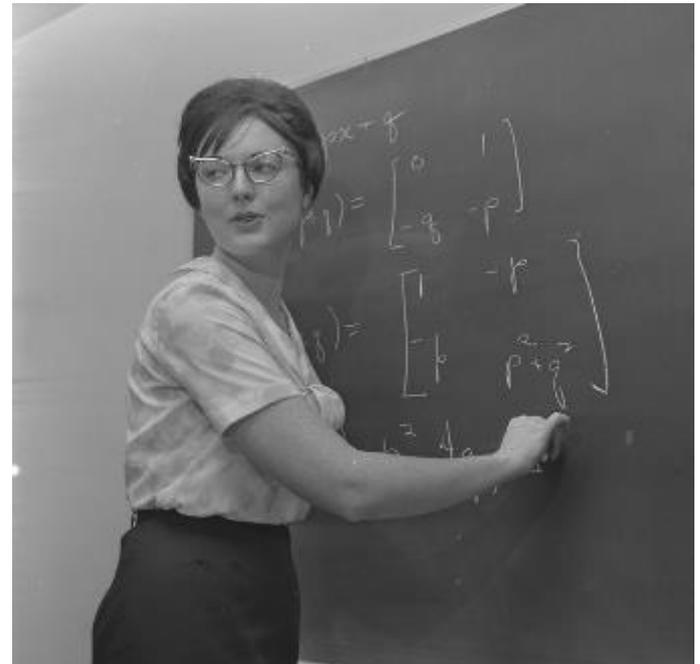
Life Insurance – Roth Hedge

It's a Balancing Act …
Bet to Live? Bet to Die?

Appendix

Different Scenarios for your review.

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ROTH CONVERSIONS

- 10-year analysis period
- 7% rate of return
- Tax paid from retirement account
- RMDs do not start within period

A positive factor indicates an effective conversion, whereas a negative factor indicates an ineffective conversion

		Rate @ Conversion						
		10%	12%	22%	24%	32%	35%	37%
Rate @ Distribution	**10%**	0.00	-0.04	-0.24	-0.28	-0.43	-0.49	-0.53
	12%	0.04	0.00	-0.20	-0.24	-0.39	-0.45	-0.49
	22%	0.24	0.20	0.00	-0.04	-0.20	-0.26	-0.30
	24%	0.28	0.24	0.04	0.00	-0.16	-0.22	-0.26
	32%	0.43	0.39	0.20	0.16	0.00	-0.06	-0.10
	35%	0.49	0.45	0.26	0.22	0.06	0.00	-0.04
	37%	0.53	0.49	0.30	0.26	0.10	0.04	0.00

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ROTH CONVERSIONS

- 10-year analysis period
- 7% rate of return
- Tax paid from retirement account
- RMDs do not start within period
- Sunset distribution rates

A positive factor indicates an effective conversion, whereas a negative factor indicates an ineffective conversion

Rate @ Distribution	Rate @ Conversion						
	10%	**12%**	**22%**	**24%**	**32%**	**35%**	**37%**
10%	0.00	-0.04	-0.24	-0.28	-0.43	-0.49	-0.53
15%	0.10	0.06	-0.14	-0.18	-0.33	-0.39	-0.43
25%	0.30	0.26	0.06	0.02	-0.14	-0.20	-0.24
28%	0.35	0.31	0.12	0.08	-0.08	-0.14	-0.18
33%	0.45	0.41	0.22	0.18	0.02	-0.04	-0.08
35%	0.49	0.45	0.26	0.22	0.06	0.00	-0.04
39.6%	0.58	0.54	0.35	0.31	0.15	0.09	0.05

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ROTH CONVERSIONS

- 20-year analysis period
- 7% rate of return
- Tax paid from retirement account
- RMDs do not start within period

A positive factor indicates an effective conversion, whereas a negative factor indicates an ineffective conversion

		Rate @ Conversion						
		10%	12%	22%	24%	32%	35%	37%
Rate @ Distribution	**10%**	0.00	-0.08	-0.46	-0.54	-0.85	-0.97	-1.04
	12%	0.08	0.00	-0.39	-0.46	-0.77	-0.89	-0.97
	22%	0.46	0.39	0.00	-0.08	-0.39	-0.50	-0.58
	24%	0.54	0.46	0.08	0.00	-0.31	-0.43	-0.50
	32%	0.85	0.77	0.39	0.31	0.00	-0.12	-0.19
	35%	0.97	0.89	0.50	0.43	0.12	0.00	-0.08
	37%	1.04	0.97	0.58	0.50	0.19	0.08	0.00

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ROTH CONVERSIONS

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		Rate @ Conversion						
		10%	12%	22%	24%	32%	35%	37%
Rate @ Distribution	10%	0.00	-0.08	-0.46	-0.54	-0.85	-0.97	-1.04
	15%	0.19	0.12	-0.27	-0.35	-0.66	-0.77	-0.85
	25%	0.58	0.50	0.12	0.04	-0.27	-0.39	-0.46
	28%	0.70	0.62	0.23	0.15	-0.15	-0.27	-0.35
	33%	0.89	0.81	0.43	0.35	0.04	-0.08	-0.15
	35%	0.97	0.89	0.50	0.43	0.12	0.00	-0.08
	39.6%	1.15	1.07	0.68	0.60	0.29	0.18	0.10

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ROTH CONVERSIONS

- **10-year analysis period**
- 7% rate of return inside retirement account
- 5.5% after-tax rate of return outside retirement account
- **Tax paid with outside funds**
- RMDs do not start within period

A positive factor indicates an effective conversion, whereas a negative factor indicates an ineffective conversion

		Rate @ Conversion						
		10%	**12%**	**22%**	**24%**	**32%**	**35%**	**37%**
Rate @ Distribution	**10%**	0.03	-0.01	-0.18	-0.21	-0.35	-0.40	-0.44
	12%	0.07	0.03	-0.14	-0.17	-0.31	-0.36	-0.40
	22%	0.26	0.23	0.06	0.02	-0.11	-0.17	-0.20
	24%	0.30	0.27	0.10	0.06	-0.07	-0.13	-0.16
	32%	0.46	0.42	0.25	0.22	0.08	0.03	0.00
	35%	0.52	0.48	0.31	0.28	0.14	0.09	0.06
	37%	0.56	0.52	0.35	0.32	0.18	0.13	0.10

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ROTH CONVERSIONS

- 10-year analysis period
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Rate @ Distribution	**10%**	0.03	-0.01	-0.18	-0.21	-0.35	-0.40	-0.44
	15%	0.12	0.09	-0.08	-0.11	-0.25	-0.30	-0.34
	25%	0.32	0.29	0.12	0.08	-0.05	-0.11	-0.14
	28%	0.38	0.35	0.18	0.14	0.00	-0.05	-0.08
	33%	0.48	0.44	0.27	0.24	0.10	0.05	0.02
	35%	0.52	0.48	0.31	0.28	0.14	0.09	0.06
	39.6%	0.61	0.57	0.40	0.37	0.23	0.18	0.15

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ROTH CONVERSIONS

- **20-year analysis period**
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Rate @ Distribution	**10%**	0.10	0.04	-0.25	-0.31	-0.55	-0.63	-0.69
	12%	0.17	0.11	-0.18	-0.24	-0.47	-0.56	-0.62
	22%	0.56	0.50	0.21	0.15	-0.08	-0.17	-0.23
	24%	0.64	0.58	0.29	0.23	0.00	-0.09	-0.15
	32%	0.95	0.89	0.60	0.54	0.30	0.22	0.16
	35%	1.06	1.00	0.71	0.65	0.42	0.33	0.27
	37%	1.14	1.08	0.79	0.73	0.50	0.41	0.35

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ROTH CONVERSIONS

- 20-year analysis period
- 7% rate of return inside retirement account
- 5.5% after-tax rate of return outside retirement account
- Tax paid with outside funds
- RMDs do not start within period
- Sunset distribution rates

A positive factor indicates an effective conversion, whereas a negative factor indicates an ineffective conversion

		Rate @ Conversion						
		10%	12%	22%	24%	32%	35%	37%
Rate @ Distribution	10%	0.10	0.04	-0.25	-0.31	-0.55	-0.63	-0.69
	15%	0.29	0.23	-0.06	-0.12	-0.35	-0.44	-0.50
	25%	0.68	0.62	0.33	0.27	0.03	-0.05	-0.11
	28%	0.79	0.73	0.44	0.38	0.15	0.06	0.00
	33%	0.99	0.93	0.64	0.58	0.34	0.26	0.20
	35%	1.06	1.00	0.71	0.65	0.42	0.33	0.27
	39.6%	1.24	1.18	0.89	0.83	0.60	0.51	0.45

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ROTH CONVERSIONS

- 10-year analysis period
- 7% rate of return inside retirement account
- 5.5% after-tax rate of return outside retirement account
- Tax paid with inside funds
- Taxpayer is age 70 and RMDs begin in the first period

A positive factor indicates an effective conversion, whereas a negative factor indicates an ineffective conversion

		Rate @ Conversion						
		10%	12%	22%	24%	32%	35%	37%
Rate @ Distribution	**10%**	0.05	0.01	-0.21	-0.25	-0.42	-0.48	-0.52
	12%	0.09	0.05	-0.16	-0.21	-0.37	-0.44	-0.48
	22%	0.29	0.25	0.04	0.00	-0.17	-0.23	-0.27
	24%	0.33	0.29	0.08	0.04	-0.13	-0.19	-0.23
	32%	0.50	0.46	0.25	0.20	0.04	-0.03	-0.07
	35%	0.56	0.52	0.31	0.27	0.10	0.03	-0.01
	37%	0.60	0.56	0.35	0.31	0.14	0.08	0.03

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A positive factor indicates an effective conversion, whereas a negative factor indicates an ineffective conversion

		Rate @ Conversion						
		10%	12%	22%	24%	32%	35%	37%
Rate @ Distribution	10%	0.34	0.25	-0.16	-0.24	-0.58	-0.70	-0.78
	12%	0.41	0.33	-0.09	-0.17	-0.50	-0.62	-0.71
	22%	0.79	0.70	0.29	0.21	-0.12	-0.25	-0.33
	24%	0.86	0.78	0.37	0.28	-0.05	-0.17	-0.25
	32%	1.16	1.08	0.67	0.58	0.25	0.13	0.05
	35%	1.28	1.19	0.78	0.70	0.37	0.24	0.16
	37%	1.35	1.27	0.86	0.77	0.44	0.32	0.23

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A positive factor indicates an effective conversion, whereas a negative factor indicates an ineffective conversion

		Rate @ Conversion						
		10%	12%	22%	24%	32%	35%	37%
Rate @ Distribution	10%	0.08	0.04	-0.14	-0.17	-0.32	-0.37	-0.41
	12%	0.12	0.08	-0.10	-0.13	-0.28	-0.33	-0.37
	22%	0.32	0.29	0.11	0.07	-0.07	-0.13	-0.16
	24%	0.37	0.33	0.15	0.11	-0.03	-0.09	-0.12
	32%	0.53	0.49	0.31	0.28	0.13	0.08	0.04
	35%	0.59	0.55	0.37	0.34	0.19	0.14	0.10
	37%	0.63	0.60	0.42	0.38	0.24	0.18	0.15

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A positive factor indicates an effective conversion, whereas a negative factor indicates an ineffective conversion

		Rate @ Conversion						
		10%	**12%**	**22%**	**24%**	**32%**	**35%**	**37%**
Rate @ Distribution	**10%**	0.44	0.38	0.07	0.01	-0.24	-0.33	-0.39
	12%	0.52	0.46	0.15	0.09	-0.16	-0.25	-0.31
	22%	0.89	0.83	0.52	0.46	0.22	0.12	0.06
	24%	0.97	0.91	0.60	0.54	0.29	0.20	0.14
	32%	1.27	1.21	0.90	0.84	0.59	0.50	0.44
	35%	1.38	1.32	1.01	0.95	0.71	0.61	0.55
	37%	1.46	1.40	1.09	1.03	0.78	0.69	0.63

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