Cut Taxes and Receive a Larger IRA

A Roth IRA is a great tool for retirement savings. Here's how to make it even better.

At the beginning of every year, we work with some of our clients to convert their IRAs to Roth IRAs, knowing, even then, that we will undo most of those conversions at the end of the year. The whole process involves a lot of paperwork and tracking of their accounts throughout the year.

So why do we go through all this trouble? It's a great way to save on taxes.

First, let's do a quick review. An IRA is typically funded with pre-tax dollars and grows tax-deferred. When the account holder withdraws the money from the account, those withdrawals are fully taxed as regular income. A Roth IRA, on the other hand, is funded with after-tax dollars, and withdrawals are tax-free.

When you convert an IRA to a Roth IRA, you have to pay regular income taxes on the amount you convert. By doing the conversion, thus, you're effectively paying income taxes *now* so that your withdrawals *later* — from the new Roth IRA — will be tax-free.

There's a twist: You're allowed to undo the conversion in the same tax year of the conversion without incurring any taxes or penalties. It is this ability to undo the conversion which provides for a great tax planning strategy.

So when and why might you want to do a Roth IRA conversion? And why might you want to undo it?

Low Income Taxes: Let's say you lost your job, and you end up having a year owing little or no income tax. You could convert some amount of your IRA to a Roth IRA without much of a tax hit. Or maybe, because you're self-employed or work on commission, your income varies widely; in a year with very low income, you could use the conversion to move money to a Roth at very low tax rates. Whatever your situation, you can convert at the beginning of the year, then depending on your earnings over the year, you can decided to keep the conversion or undo.

Topping off Your Tax Bracket: Similar to the low income taxes, if you find yourself in a lower-than-expected tax bracket, you may want to keep some of the conversion to fill up that lower tax bracket.

Investment Performance: The more your assets increase in value after conversion, the better. Since no one can time the markets, however, the best strategy (again) is to convert at the beginning of the year. Then, as year-end approaches, you can decide if the conversion was worthwhile. Let's say, for example, that you convert a $10,000 IRA to a Roth in January. If in December the Roth is worth $15,000, you'll still pay taxes only on the $10,000 you converted — a pretty good deal. If, however, the account is worth only $5,000 by December, you'd still have to pay taxes on that original $10,000 you converted. So if the converted assets lose money, you can just undo the conversion and pay no taxes on it at all.

If you're taking this wait-and-see approach, you can increase your tax advantages even further — as we do with clients — by converting IRAs into multiple Roth accounts. In this multiple-account strategy, we put different assets into each new Roth. That process lets you select the asset that had the best returns after the conversion and keep it as a Roth, while undoing the conversion of other assets with low or negative returns.

To explain this strategy, let me use the hypothetical example of Sally, a self-employed graphic designer with $40,000 in a traditional IRA. In March 2014, she converts that IRA into a Roth.

For illustrative purposes, let's suppose that she divides up her new Roth by investing $10,000 apiece in four different index funds, each representing a different asset class:

US large-cap stocks

US small-cap value stocks

International large-cap stocks

International small-cap value

At the end of November, Sally has more business income than she expected, and she decides that she would like to convert only $10,000 to a Roth — one-quarter of the original $40,000.

Let's take a look at where her account has ended up:

	Initial Investment	**Total Return**	**End Value**
US Large-cap	$ 10,000	12.89%	**$** 11,289
US small-cap value	$ 10,000	0.91%	$ 10,091
International large-cap	$ 10,000	-2.39%	$ 9,761
International small-cap value	$ 10,000	-8.09%	$ 9,191
TOTAL	**$ 40,000**	**0.83%**	**$40,332**

The usual approach, in this situation, would have been for Sally to convert the entire IRA into one new Roth conversion account. In such a case, since she wants to convert

only one-quarter of the original amount, she will be able to keep only one-quarter of her $40,332 balance at the end of November, or $10,083.

But the strategy we use would be to open four separate Roth conversions — one for each asset class. In that case, when Sally wants to undo the conversion on three-quarters of her original $40,000, she can keep the Roth account with the best return and undo the conversion on the other three. In this particular example, she would keep the US large-cap fund in her Roth, which is now worth $11,289.

So under this four-account option, she starts out with exactly the same investments as in the original scenario, and has exactly the same tax liability on the $10,000 Roth conversion she doesn't undo. But she also ends up with $11,289 in her Roth account, not the $10,083 she would have had by converting into a single account. That's an extra $1,206 in the Roth, for no added tax liability.

The following year, Sally can take the $29,000 that reverted to her traditional IRA and do the conversion all over again. (IRS rules dictate that once you've reversed an Roth conversion, you have to wait at least 30 days, and until a new calendar year, to do another.)