Affluent households and the retirement tax cliff

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IN BRIEF

- For many retirees, taxable income and tax liability increase when required minimum distributions (RMDs) begin at age 70½; some see their federal marginal tax bracket jump one or even two brackets.
- A Roth conversion strategy can help reduce the taxes that must be paid over the course of retirement. It can also help to maximize the value and tax efficiency of inherited retirement accounts.
- Leveraging the unused space within an individual's top tax bracket may provide an opportunity to take a proactive distribution from a retirement account and convert those funds to a Roth IRA. The more unused space within the top tax bracket, the more opportunity there is for a proactive distribution and a Roth conversion.
- For affluent and high net worth (HNW) households, the major building blocks that could make a successful Roth conversion strategy include the individual's top marginal tax bracket, time before RMDs begin and having the right mix of account types. Among the risks to consider: longevity, portfolio returns and legacy concerns.

Over the past few decades, tax planning for retirement has become more complex. As a result of changes in the tax code and recent legislation, many affluent Americans may not only see their individual income tax rates increase, but may also be subject to the Medicare surtax on investment income, limits or phase-outs of certain deductions and personal exemptions and an increase in Medicare premiums.

For many retirees with tax-deferred accounts, taxable income and tax liability increase when RMDs begin, and some see their federal marginal tax bracket jump one or even two brackets once they turn age 70½. This is what we refer to as the retirement tax cliff.

Last year, we developed research that tested a well-known theory of utilizing a targeted Roth conversion strategy during the early retirement years. We found that for mass affluent individuals (households with about $1 million in retirement assets) a Roth conversion strategy may help reduce total taxes paid in retirement, diversify assets and provide legacy planning benefits.

In this paper, we will evaluate whether a Roth conversion strategy delivers income tax and legacy planning benefits for affluent and HNW individuals in retirement. In the following pages we discuss:

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- Whether HNW individuals can leverage Roth conversions in retirement to help mitigate their taxes over the long term
- What factors individuals should consider to determine whether a Roth conversion strategy may be effective
- What steps pre-retirees can take now to increase retirement savings and minimize taxes later

AVOIDING THE RETIREMENT TAX CLIFF

For many individuals, the early retirement years tend to allow for greater control over income tax liability, as most individuals can leverage tax efficient strategies and Social Security to meet spending needs. Once RMDs begin, however, tax liability tends to increase, not only as a result of the size of the RMD but also because the distribution is subject to ordinary income tax.

One way to reduce RMDs—and taxes—over an individual's retirement is to utilize a Roth conversion strategy. The key to leveraging this strategy is to first identify an individual's top marginal tax bracket based on current annual taxable income. Once the top marginal tax bracket for a given year is identified, one can then determine how much more income an individual can report—how much unused space there is within the tax bracket—before the individual hits the top of the tax bracket or moves into the next tax bracket (**EXHIBIT 1**).

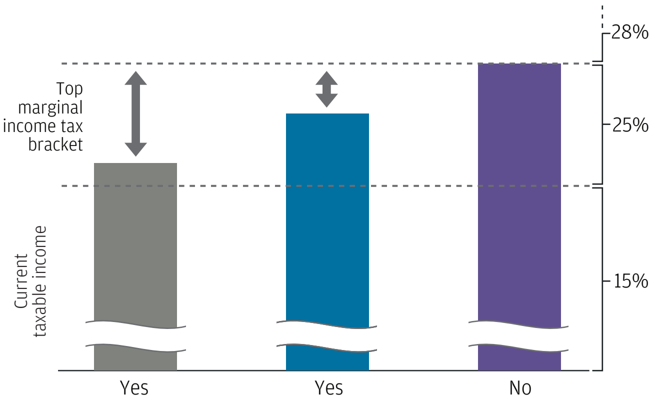
The more unused space within the top tax bracket, the more opportunity there may be for a proactive Roth conversion.

In research we conducted over the past two years, we analyzed whether a Roth conversion strategy may help mass affluent retiree households minimize the taxes they pay in retirement and maximize the legacy left to their beneficiaries. In our first tax cliff analysis, we compared three scenarios, all with similar assumptions.

Each couple began retirement with a $1 million portfolio split 50/50 between taxable and tax-deferred accounts. Early in retirement, each couple drew first from their taxable account and then collected Social Security benefits to meet spending needs. Comparing the approaches to RMD timing, the couple that waited until age 70½ to start RMDs received the most RMDs and paid the most taxes in retirement of all three couples. On the other hand, the couple that took advantage of the unused space below the top of their marginal tax bracket, withdrew that amount each year as a distribution from their

Leverage the unused space within an individual's top income tax bracket

EXHIBIT 1: THE MORE SPACE BELOW THE TOP OF THE BRACKET, THE MORE OPPORTUNITY FOR A ROTH CONVERSION



For illustrative purposes only.

retirement account and invested it into their taxable account had a very different experience. They were able to cut their RMDs in half compared to the first couple and paid about $50,000 less in overall taxes.

A third couple opted for a Roth conversion, taking proactive distributions from their tax-deferred accounts early in retirement and converting those amounts to a Roth IRA. This approach proved the most effective. Not only did the couple cut their tax bill significantly, but they also had the largest and most tax-efficient retirement account to pass on to their beneficiaries. That is because the distributions from the Roth account would be income tax free to the beneficiaries (**EXHIBIT 2**).

For million dollar households, the Roth conversion approach delivered the greatest tax savings

EXHIBIT 2: MILLION DOLLAR HOUSEHOLDS: THREE APPROACHES

	The RMD approach	The Taxable Account approach	The Roth Conversion approach
Total ending wealth*:	$1,573,387	$1,589,777	$1,907,073
Taxable portfolio:	$1,079,944	$1,311,015	$157,192
Tax-deferred*:	$493,443	$278,762	$196,162
Roth:	N/A	N/A	$1,553,719
Total RMDs:	$1,335,490	$743,734	$520,255
Ordinary income taxes:	$293k	$241k	$53k

*Represents final portfolio after average effective federal taxes.
Source: J.P. Morgan Asset Management.

As our first tax cliff analysis underscored, a Roth conversion strategy early in retirement can help many mass affluent households gain more control over their tax burden and therefore reduce the taxes they must pay over the course of their retirement. It can also help them to maximize the value and tax efficiency of the inheritance they leave to their heirs.

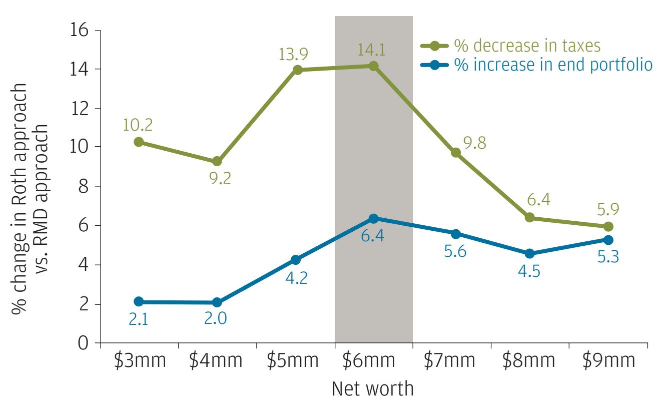
THE ROTH CONVERSION STRATEGY FOR AFFLUENT HOUSEHOLDS: BUILDING BLOCKS AND CONSIDERATIONS

As more individuals enter retirement with substantial assets and large tax-deferred accounts, does the Roth conversion strategy provide the same benefits as it does for some mass affluent households? Can taking proactive distributions from tax-deferred accounts early in retirement and converting those amounts to a Roth IRA result in lower overall taxes and greater ending account values for those at higher wealth and income levels? And what are the factors and risks to consider when applying this strategy?

These are among the questions we addressed in our second tax cliff analysis. Here we examined portfolios ranging from $3 million to $15 million, with varying proportions of taxable vs. tax-deferred accounts, spending needs and other factors. We found there are certain building blocks that a household should consider to position itself to take advantage of the Roth conversion strategy, as well as certain factors/risks to be mindful of that could influence its overall effectiveness (**EXHIBIT 3**).

The benefits of a Roth conversion are determined by account size, the mix of account types and tax brackets

EXHIBIT 3: THE BENEFITS OF A ROTH CONVERSION STRATEGY IN A 50/50 MIX RETIREMENT ACCOUNT



Source: J.P. Morgan Asset Management.

Building blocks

- **Top marginal tax bracket:** The lower the individual's top marginal tax rate is, the better. The marginal tax bracket may be affected by several factors, including the amount of investment income and withdrawals or gains realized to meet spending needs, the overall portfolio value and mix of assets.
- **Time before RMDs begin:** The more time an individual has to leverage a lower tax bracket before RMDs begin and to shift tax-deferred assets to a Roth account, the better the outcome.
- **Mix of account types:** The mix of account types largely determines whether a Roth conversion strategy will work. A $5 million taxable account will have substantially different tax characteristics when compared with a $5 million traditional IRA account. When there is a well-proportioned mix of accounts—including taxable, tax-deferred and even tax-free portfolios—the more flexibility an individual has to manage taxes during his/her retirement.

Risks to consider

- **Longevity risk:** Because the Roth strategy requires a shift in payment of taxes to the first few years, the longer an individual lives, the greater the potential for tax savings and legacy benefits. On the other hand, a premature death may mean that the individual pre-paid taxes unnecessarily.
- **Portfolio return risk:** Portfolio returns—especially if a client enters retirement in a bear or down market and begins tapping taxable assets—may also have a negative effect on this strategy.
- **Legacy transfer risk:** To the extent that individuals wish to optimize their legacy and transfer assets to their heirs in a tax-efficient fashion, a Roth conversion may not be the appropriate strategy for certain HNW households who may tap the most tax-efficient accounts during retirement and leave the least income tax-efficient accounts for their beneficiaries. This may happen when an individual has substantial retirement assets, extremely high annual spending needs and a retirement portfolio comprised primarily of tax-deferred vs. taxable accounts.

CASE STUDIES: COUPLE A, B AND C

To test whether the Roth conversion strategy may be effective for affluent/HNW households, we put together three different scenarios to compare tax savings and ending account value for an RMD approach and a Roth conversion. Each couple has a $6 million portfolio. The portfolios of the first two couples are split 50/50 between taxable and tax-deferred retirement accounts, while the third couple has a different asset breakdown. Each couple will draw from their taxable assets first (**EXHIBIT 4**).

Meet the $6 million households

EXHIBIT 4: PROFILES OF THREE COUPLES WITH $6 MILLION PORTFOLIOS

Couple A	Couple B	Couple C
The HNW household	Retire later	Mix of accounts
Married couple, same age, retire at age 60	Married couple, same age, retire at age 65	Married couple, same age, retire at age 60
$6 million portfolios split 50/50 between taxable account and IRA/401(k)	$6 million portfolios split 50/50 between taxable account and IRA/401(k)	$6 million portfolio, split 20/80 and 80/20 between taxable account and IRA/401(k)
Begin claiming Social Security at age 66 (Full Retirement Age). Maximum wage earners plus a spousal benefit from a Social Security perspective. Initial spending need: $240,000, grown by 1.5%. All couples draw from taxable assets first.		

COUPLE A

The first scenario compares drawing retirement assets according to the RMD approach vs. the Roth conversion approach. Couple A has a $6 million retirement portfolio with an evenly split mix of accounts. They retire at age 60, tap taxable assets, claim Social Security benefits at age 66 and wait until age 70½ to tap their tax-deferred accounts.

From age 60 to 66, Couple A draws from taxable accounts to satisfy their spending need. At age 66, Couple A starts receiving Social Security benefits and at age 70½ they begin RMDs from retirement accounts.

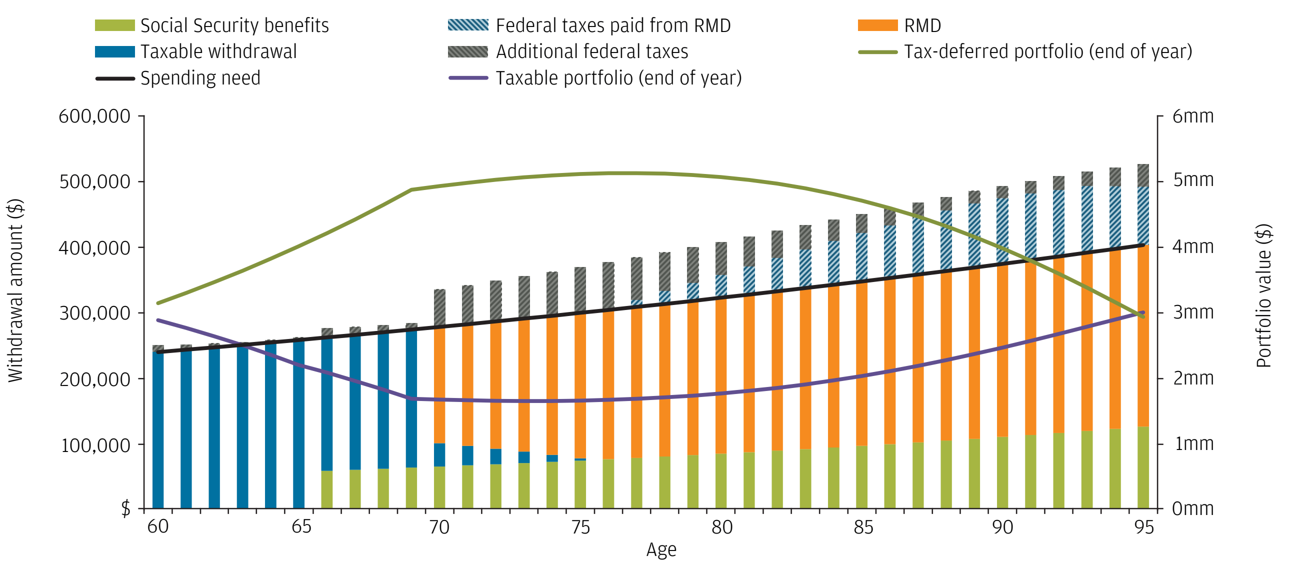
What are the tax consequences? Even though their spending need was $240,000, they were able to stay below the 15% tax bracket until age 70½ because they were drawing first from taxable accounts and then from Social Security. But at 70½, when they had to start RMDs, their top tax rate was bumped up two brackets to 28%, and it stayed very close to the top of the 28% tax bracket throughout retirement.

What happens if Couple A uses the Roth conversion strategy instead of waiting for RMDs? Early in retirement they tap their taxable account. At the same time, they also take advantage of any unused space below the top of their top marginal tax bracket; they do this taking proactive distributions from their tax-deferred accounts and converting that amount each year to a Roth IRA. By age 70½, when they must begin RMDs, they have managed to reduce their tax-deferred account and reduce RMDs, as well as accumulate wealth in their Roth account (**EXHIBITS 5** through **8**).

What are the overall results of these approaches? Using the Roth strategy, Couple A paid $2.16 million in taxes overall vs. $2.51 million for the RMD approach. The Roth approach saved them about 14% in taxes during that time period. From a legacy perspective, the Roth approach achieved 6% greater wealth and even provided for a better mix of retirement accounts. Therefore, we see meaningful value in opportunistically using the Roth conversion strategy even for a few years, particularly in a lower return world (**EXHIBIT 9**).

Couple A waits until age 70½ to tap their tax-deferred accounts

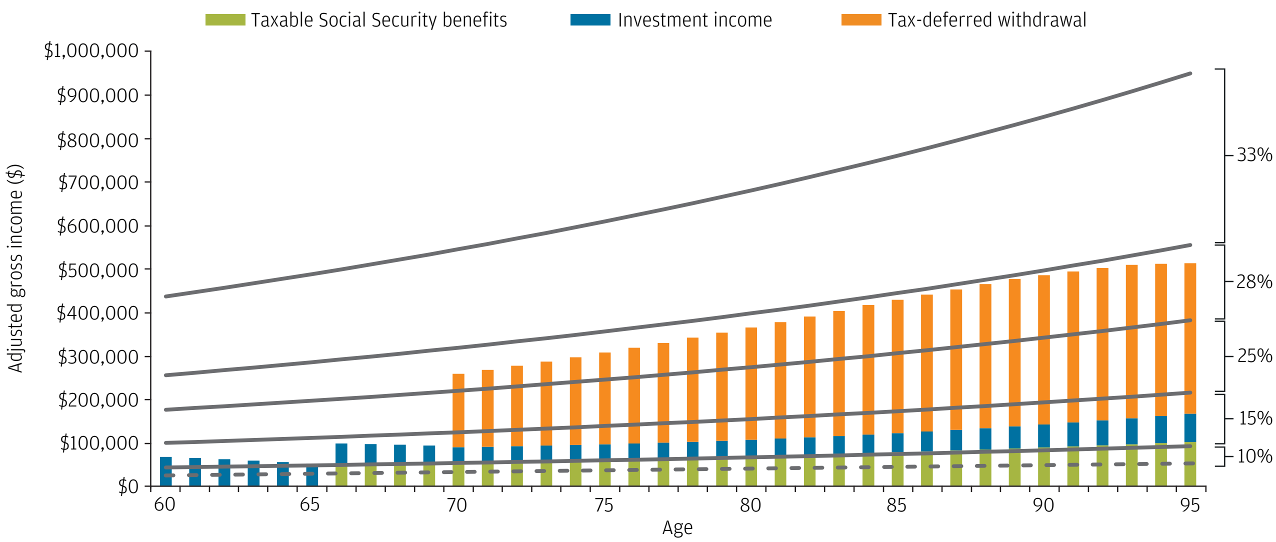
EXHIBIT 5: COUPLE A—RMD APPROACH



Note: Does not include capital gains income since it is taxed differently.
Source: J.P. Morgan Asset Management.

Couple A's income tax rate jumps two brackets at age 70½

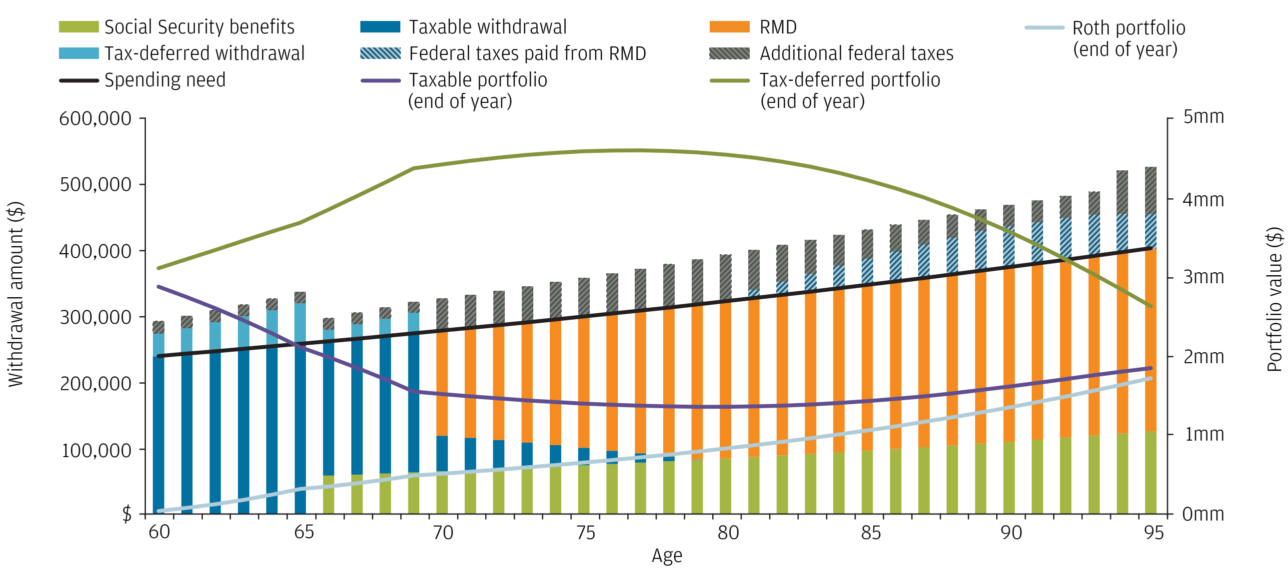
EXHIBIT 6: COUPLE A—INCOME TAX PICTURE FOR RMD APPROACH



Note: Does not include capital gains income because it is taxed differently.
Source: J.P. Morgan Asset Management.

For Couple A, the Roth approach saves about 14% in taxes compared with the RMD approach

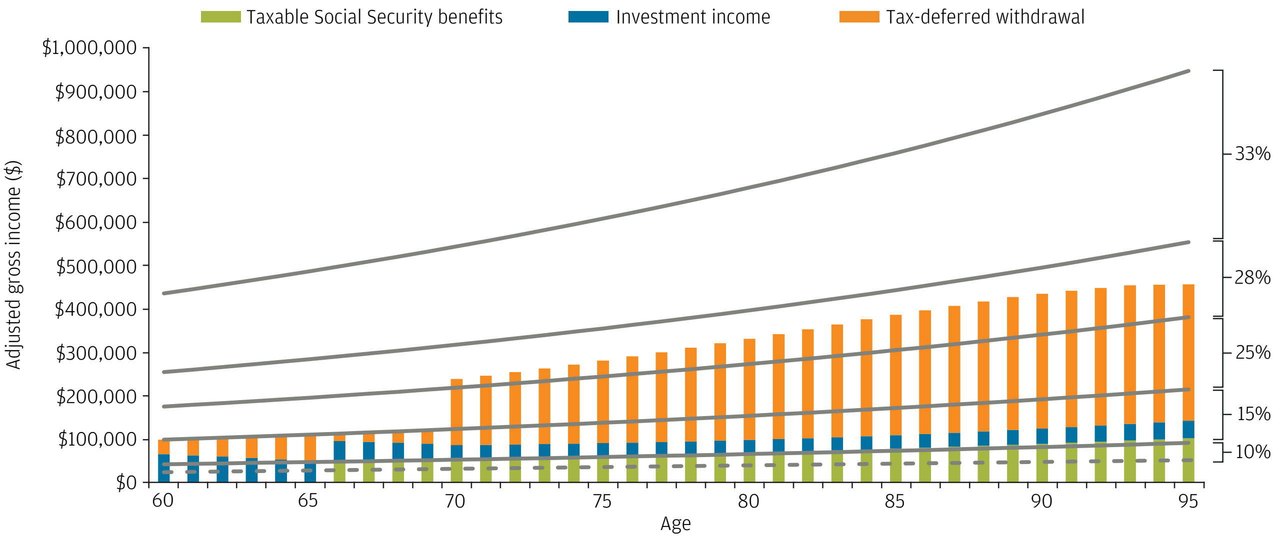
EXHIBIT 7: COUPLE A—ROTH APPROACH



Note: Does not include capital gains income since it is taxed differently.
Source: J.P. Morgan Asset Management.

Couple A leverages their top tax bracket early in retirement to save taxes later

EXHIBIT 8: COUPLE A—ROTH APPROACH AND INCOME TAX BRACKETS

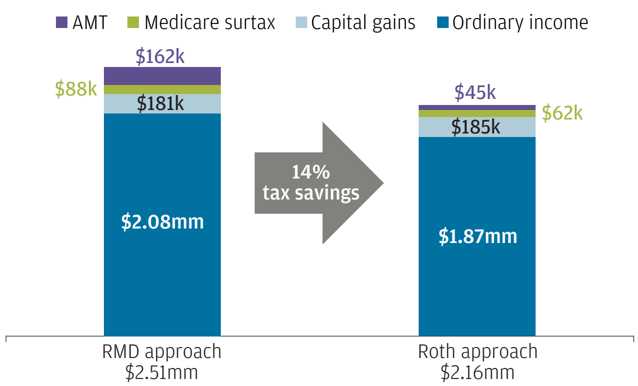


Note: Does not include capital gains income since it is taxed differently.
Source: J.P. Morgan Asset Management.

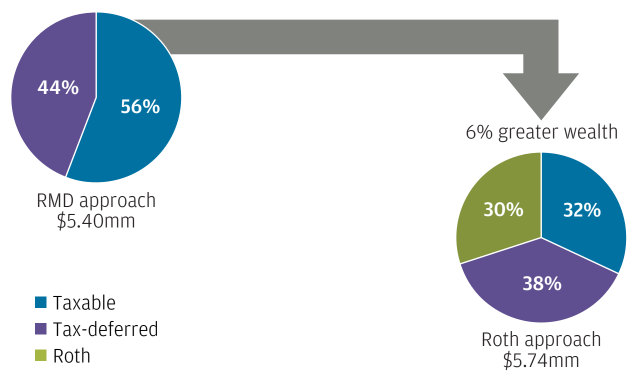
A Roth conversion can both help to reduce taxes and increase ending wealth

EXHIBIT 9: COUPLE A—A COMPARISON OF ROTH AND RMD APPROACHES

9A: TAXES



9B: ENDING WEALTH



Source: J.P. Morgan Asset Management.

COUPLE B

What happens when the couple is the same age and has the same assets and asset mix as Couple A—but because they want to retire at age 65, they have fewer years to leverage Roth conversions before they must begin RMDs at age 70½?

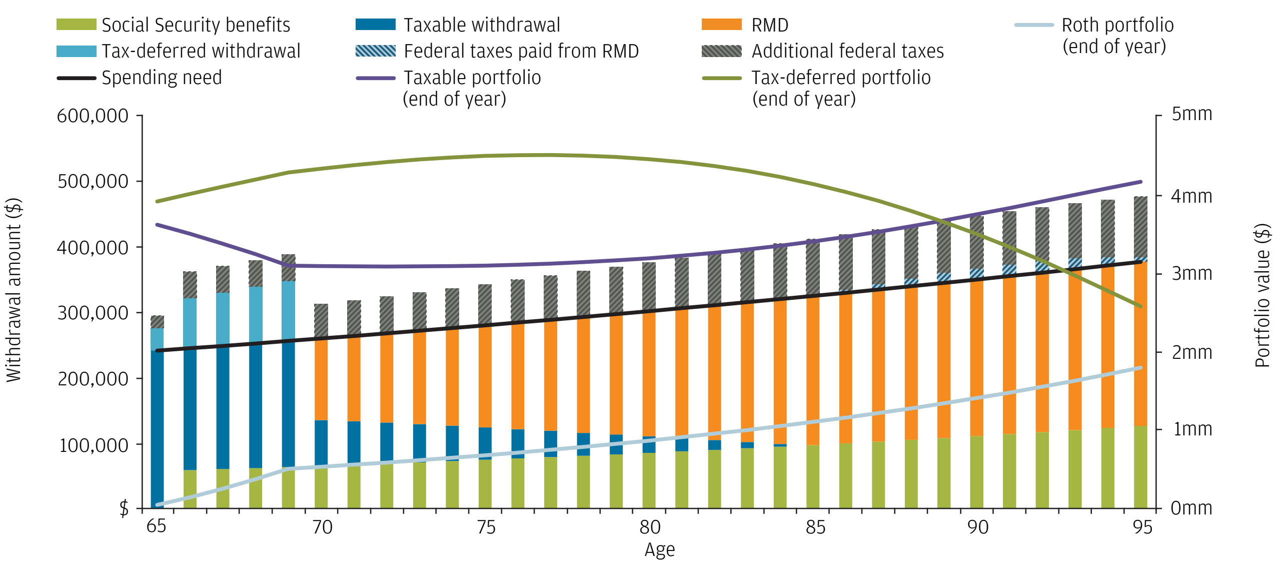
If they follow the RMD approach, their results will be similar to Couple A's results: the retirement tax rate remains in the 15% top tax rate until age 70½; and because they wait until age 70½ to begin RMDs, their RMDs start high and stay high. Their tax rate will also jump to the 28% tax bracket at age 70½.

If they follow the Roth conversion strategy, Couple B will have results similar to those realized by Couple A in the previous example. While Couple B will have missed out on five years of doing proactive Roth conversions, during the last five years before RMDs begin at age 70½, they can take proactive withdrawals up to the top of their top marginal tax bracket. Like Couple A, Couple B also went up to the 28% tax bracket at age 70½ but they were better able to maintain their tax liability going forward.

Had they waited until age 70½ to begin RMDs, they would have paid $2.52 million in taxes overall vs. $2.23 million in taxes with the Roth approach—about 11% in overall tax savings. This is just slightly lower than the 14% in tax savings achieved using the Roth conversion approach in the first example with Couple A. The Roth approach taken by Couple B delivers a 5% increase in the overall value of the ending balance of the retirement portfolio, including the taxable, tax-deferred and Roth accounts (**EXHIBITS 10, 11** and **12**).

Couple B missed out on five years of proactive Roth conversions, but they are still able to leverage the last five years before RMDs begin at age 70½

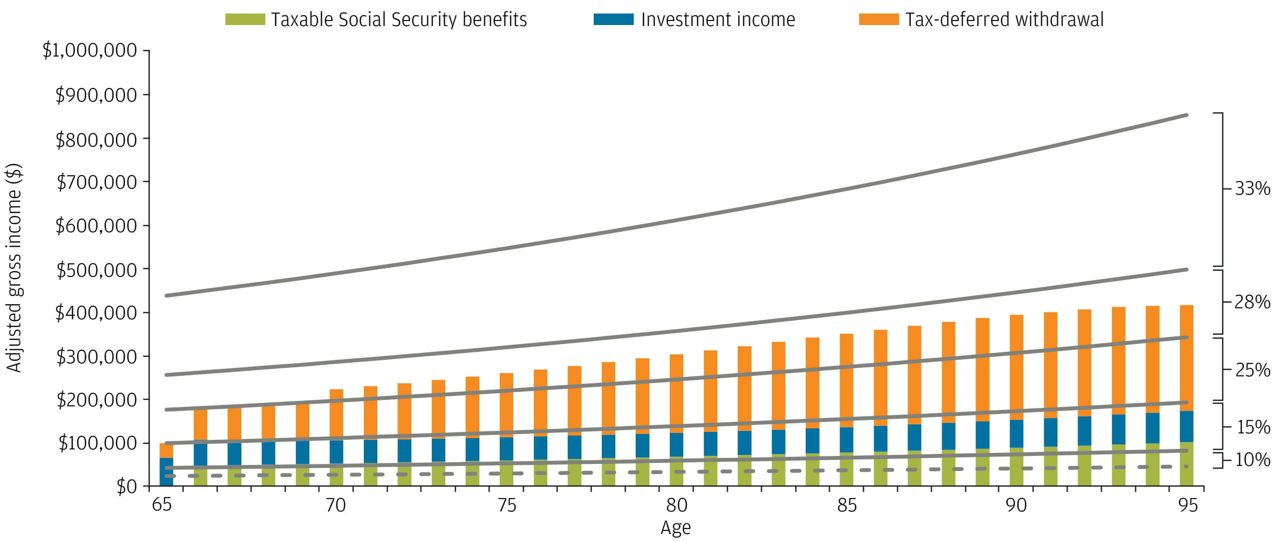
EXHIBIT 10: COUPLE B—ROTH APPROACH



Note: Does not include capital gains income since it is taxed differently.
Source: J.P. Morgan Asset Management.

In early retirement years, Couple B takes proactive withdrawals up to the top of their top marginal tax bracket

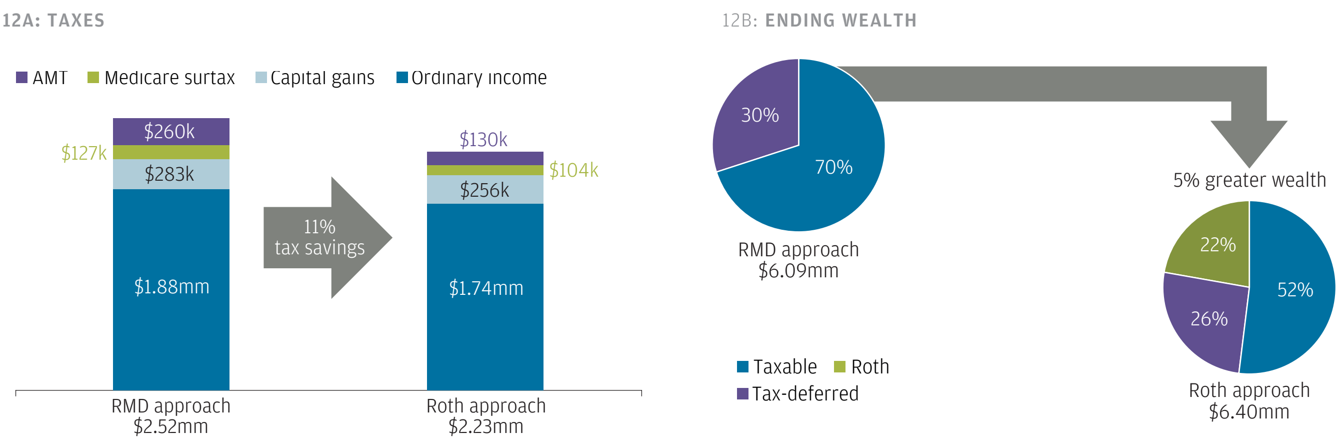
EXHIBIT 11: TAX CONSEQUENCES OF THE ROTH APPROACH



Note: Does not include capital gains income since it is taxed differently.
Source: J.P. Morgan Asset Management.

For Couple B, a Roth conversion delivered tax savings and greater ending wealth

EXHIBIT 12: COUPLE B—A COMPARISON OF ROTH AND RMD APPROACHES



Source: J.P. Morgan Asset Management.

COUPLE C: IT'S ALL ABOUT THE MIX

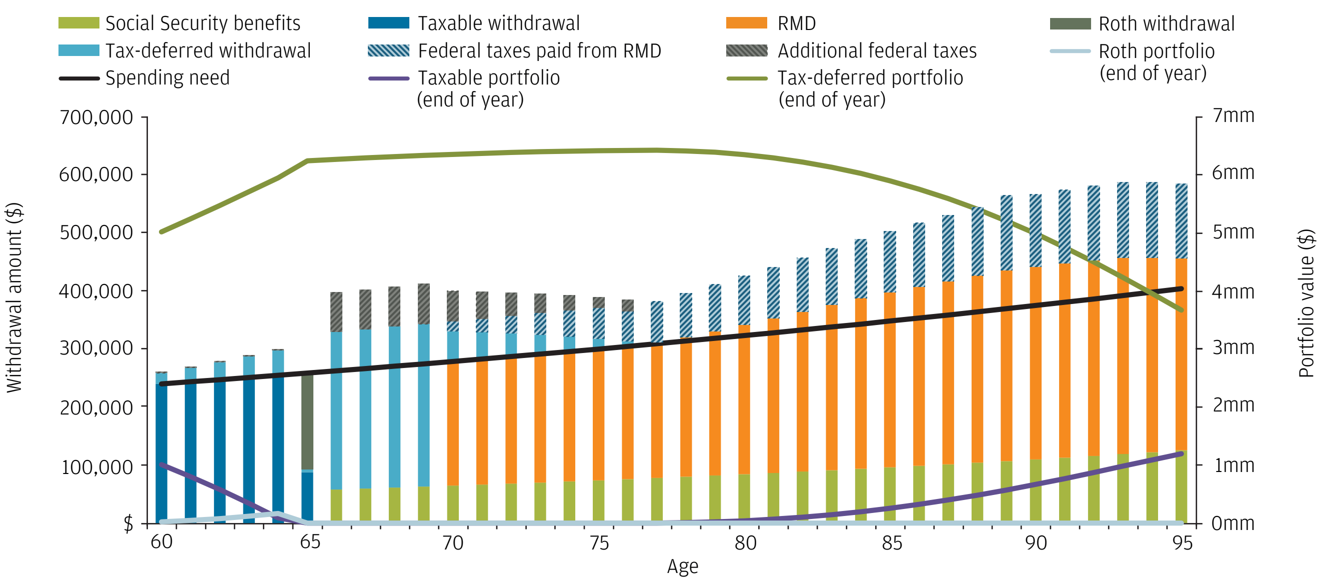
Another major factor plays a role in determining how effective the Roth conversion strategy will be: the mix of retirement accounts. With Couple C, we examined how the proportion of tax-deferred to taxable accounts can drastically influence income tax and ending wealth results. On the one hand, in a portfolio that consists of 80% in tax-deferred accounts and 20% in taxable accounts, Couple C has very little flexibility and few opportunities for Roth conversions in the early years. In fact, by age 65 they have depleted both their taxable and Roth accounts in meeting their spending needs. Thereafter, their income is drawn from their tax-deferred account and Social Security payments.

However, if Couple C's retirement portfolio consisted of 80% in a taxable account and only 20% in a tax-deferred account, the cash flow and tax picture would be very different. Because a significant chunk of their portfolio is in a taxable account, they can fully leverage the years between age 60 and 70 to take advantage of lower marginal tax brackets and do the Roth conversions. There is little to no savings between the RMD and Roth conversion approaches when the portfolio is comprised of 20% taxable accounts and 80% tax deferred accounts (**EXHIBITS 13, 14** and **15**).

To be clear, saving in tax-deferred vehicles is one of the best ways to save for retirement for many reasons: there is power in tax-deferred compounding and growth, tax deferral provides great asset location opportunities by placing income-producing and tactical assets in a tax-deferred account and individuals can maximize retirement savings by making pre-tax contributions and receiving an employer match. But individuals who have fully leveraged tax deferral and have few assets in taxable or tax-free accounts will have little ability to control income taxes in retirement. They should start shifting some savings to Roth accounts.

The proportion of tax-deferred to taxable accounts can dramatically influence income tax and ending wealth results

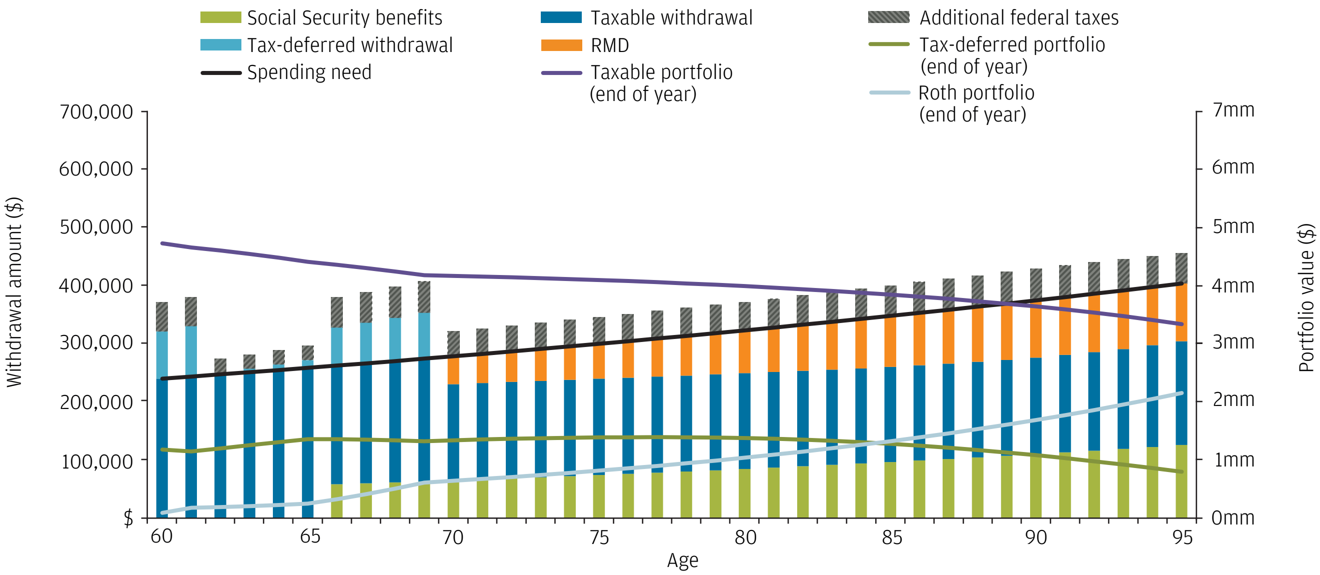
EXHIBIT 13: COUPLE C: ROTH APPROACH, 20/80, TAXABLE/TAX-DEFERRED



Note: Does not include capital gains income since it is taxed differently.
Source: J.P. Morgan Asset Management.

A couple with 80% of their portfolio in taxable accounts can do Roth conversions between age 60 and 70, taking advantage of lower marginal tax brackets

EXHIBIT 14: COUPLE C—ROTH APPROACH, 80/20, TAXABLE/TAX-DEFERRED

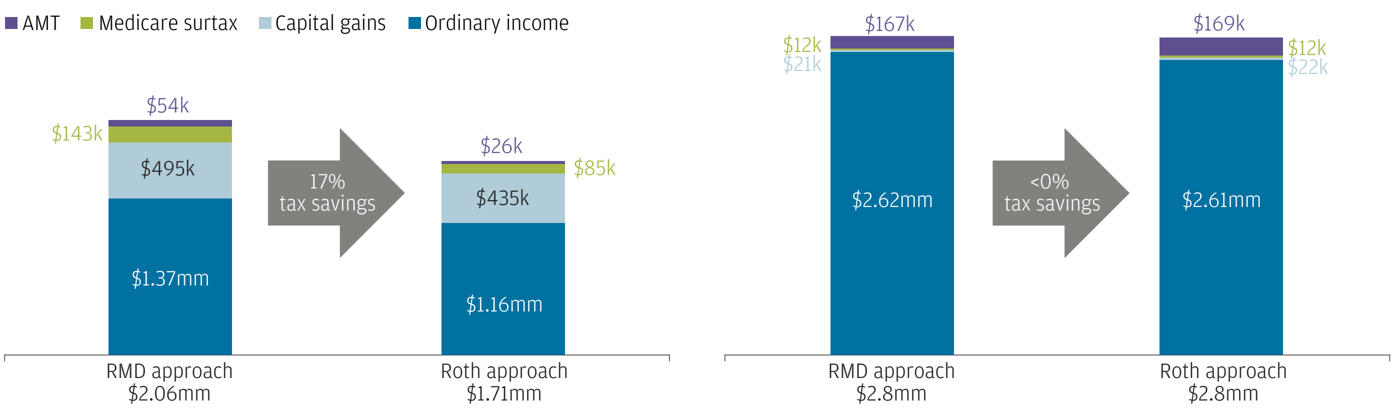


Note: Does not include capital gains income since it is taxed differently.
Source: J.P. Morgan Asset Management.

The mix of retirement accounts matters

EXHIBIT 15: 80/20 (TAXABLE/TAX-DEFERRED)

20/80 (TAXABLE/TAX-DEFERRED)



Source: J.P. Morgan Asset Management.

Mix it up even more with a Roth 401(k) account

When it comes to having the right mix of retirement accounts, individuals who are still working and have access to a Roth 401(k) may want to consider shifting retirement savings into a Roth 401(k). In deciding whether to contribute after-tax dollars to a Roth 401(k), individuals should consider the tradeoffs, potentially gaining long-term tax savings by having a mix of retirement assets that includes a Roth 401(k), but having to pay extra tax up front, foregoing the tax benefits that come with making pre-tax contributions to a traditional 401(k).

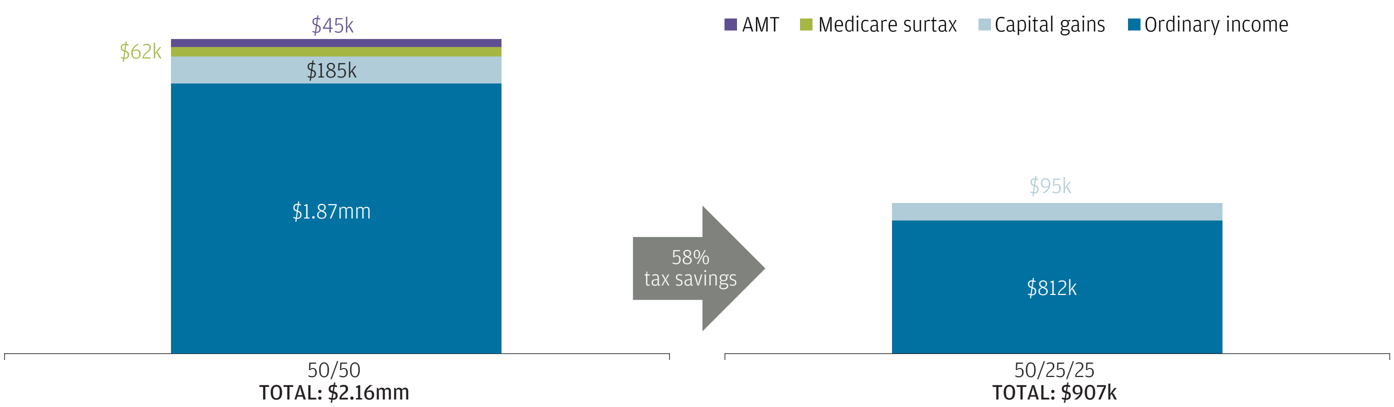
What are the implications of beginning retirement with a Roth 401(k) account? Individuals who are able to save for retirement in a taxable account, traditional 401(k) and a Roth 401(k) will be better able to diversify how they manage their tax picture in retirement. In the final example of Couple C, they begin retirement with an even better mix of accounts, including half of their portfolio in a taxable account and the other half split between a traditional 401(k) and a Roth 401(k).

In this example, Couple C waits until age 70½ to begin RMDs. They realize a significant tax savings because they have already diversified their accounts and can thus minimize taxes over the long term. And because of the mix of their accounts, they don't even need to do Roth conversions in retirement to have a better outcome (**EXHIBIT 16**).

Couple C: Diversify taxes in retirement by contributing to a Roth 401(k) account during working years

EXHIBIT 16: 50/50 – ROTH APPROACH TAXABLE/TAX-DEFERRED

50/25/25 – RMD APPROACH TAXABLE/TAX-DEFERRED/ROTH



Source: J.P. Morgan Asset Management.

CONCLUSION

We believe retired households can find meaningful value using the Roth conversion strategy for even a few years, particularly as we enter a lower return world. Individuals across the wealth spectrum should work with their CPA, financial advisor and tax advisor to evaluate whether leveraging unused space within their top tax bracket would enable them to utilize a targeted Roth IRA conversion strategy in retirement. Retirees should understand there are certain building blocks that they should consider to position themselves to take advantage of the Roth conversion strategy. In addition, there are certain factors/risks that could influence how effective the strategy will be.

When it comes to having the right mix of retirement accounts, individuals who are still working and have access to a Roth 401(k) may want to consider shifting annual retirement contributions into a Roth 401(k). Individuals who are able to save in a taxable account, a traditional 401(k) and a Roth 401(k) will be better able to diversify taxes in retirement.

As we have seen, once RMDs begin at age 70½, a retiree's federal marginal tax bracket can jump one or even two brackets, leading to unforeseen tax obligations. Whether a household is affluent, mass affluent or high net worth, it is critically important to understand and navigate the complex tax code to carefully manage income taxes in retirement and, ideally, minimize the tax payments that can erode retirement savings.

CASE STUDY ANALYSIS: TAX ASSUMPTIONS AND MODELING

While Congress continues to debate various proposals to overhaul or simplify the tax code, our case study scenarios assume no drastic change in the code in the near future.

Our model applies the prevailing tax code to retirement cash flows with a 2.5% inflation rate for an increase in tax rates and in the Social Security annual cost of living adjustments. Each analysis incorporates a Social Security benefit at full retirement age (FRA). The benefit is based on one maximum wage earner plus the spousal benefit, which is 50% of the working spouse's FRA. In the taxable account, we assume that 80% of equity gains in after-tax savings accounts are realized each year.

In all three case studies, we claimed the greater of the standard deduction (married), personal exemption (x2) and elderly deduction (x2) or itemized deductions that included the charitable deduction based on 1% of total income, as well as the imposition of a 6% state income tax. When applicable, the model applied the 3.8% Medicare surtax on investment income above the $250,000 income threshold for a married couple as well as the income phase-outs for the alternative minimum tax (AMT).

For Couples A and C, we assumed the maximum time horizon for taking proactive distributions from tax-deferred accounts without penalty (i.e. ages 60-70). Couples A and C retired earlier than the median U.S. retirement age (age 65). We note that most individuals will have less than a decade between the start date of their retirement and the start date of RMDs (age 70½), during which time it may make sense to take proactive distributions. When earned household income during early retirement is substantial, proactive strategies may not be as effective as they are in our scenarios.

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