



BY MARIE SWIFT

The Conversion Conversation

Tax diversification may be as important as portfolio diversification.

In September while at the FPA National Convention in Seattle, I was doing my usual thing: trolling the hallways for interesting conversations and ideas to bring to Research readers. As luck would have it, I ran into Steve Medland, CFP®, a wealth manager who along with partner Bob Kargenian, a Chartered Market Technician, serve an affluent clientele in Orange County, California. Their firm, TABR Capital Management, LLC, manages approximately \$150 million of client capital for more than 220 households nationwide. I asked Steve how the conference was going for him. What was the most interesting session so far?

“I’m really excited about what I learned in the tax diversification session,” he told me. “No kidding,” I replied. “How so? That sounds pretty dull compared to some of the business building sessions on the practice management track.”

“Not so,” explained Steve. “Bob and I are well established and don’t really need to market our firm right now. We’ve got lots of good clients and strategic partners who keep referring business to us, so growth is happening quite nicely through an organic process. What we need more of—and what I’m here to gather—are good ideas to help our clients meet their financial goals.”

“Ok, so tell me more about the tax diversification session,” I said. “Well, I’ve been thinking about this for some time,” Steve explained. “And it was just great to have an executive from Vanguard validate my thoughts. The presenter explained that tax diversification is as important as portfolio diversification.”

“In addition to longevity and inflation risks, people are facing tax uncertainties.



No one knows if taxes will be up or down when they need to tap into their retirement savings. Therefore building into a client’s financial plan what Vanguard calls tax diversification could be a good thing. For instance, if the client had both Traditional IRA and Roth IRA money to draw from, as needed in their golden years, they would have a degree of flexibility as to which pot of money it would be best to tap into, depending on the tax situation at the time.”

Medland proceeded to provide an example of how a younger (Gen X) couple could turbo-charge their retirement savings by max funding their traditional (non-deductible) IRAs for the next 4 years. In this example, they currently make \$166,000+ annually in combined income—too much to qualify for making Roth IRA contributions. But they should still sock

away the \$38,000 in a traditional IRA with the intention of converting the money to a Roth IRA in 2010, when the IRS restrictions for conversion are lifted. Currently, a taxpayer with modified adjusted gross income (MAGI) over \$100,000 is not eligible to convert to a Roth IRA.

“So, let me make sure I understand this,” I said. “Because they are both under the age of 50, they can each put \$4,000 into their traditional IRAs in 2007, \$5,000 in 2008, \$5,000 in 2009, and \$5,000 in 2010. That would give them \$38,000 (plus whatever market returns or dividends they earned) in their traditional IRA in 2010.” “Right,” said Steve. “In addition, they should also set aside about \$1,600 to cover the amount of taxes that might feasibly be due on their earnings when they convert to a Roth IRA in 2010. You generally pay



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Steve Medland, CFP®, a partner at Tabr Capital Management, LLC says a couple could turbo-charge their retirement savings by max funding their traditional (non-deductible) IRAs for the next 4 years then converting the account to a Roth IRA in 2010 when the restrictions for conversion are lifted.

ordinary federal income tax (but not a 10% penalty tax) on the taxable amount that is converted. Your tax-free potential is maximized if you pay the taxes from your current income or personal savings, not from your IRA. But they have good incomes now and should have the cash flow or savings to make the conversion in 2010.”

“Why is this so exciting to you?” I asked. “The exciting thing is that the Roth IRA money – both the principal and the earnings – will never be taxed again,” said Steve. “If they let that nest egg grow tax-free for the next 20 years, that could be a nice chunk of retirement money – and the distributions would be tax-free too.” After 2010, the Roth IRA income limits will remain, but they can be effectively bypassed by making a traditional IRA contribution and then doing a conversion to a Roth in the same year.

“Ok, so that’s the turbo-charge-your-retirement part. What about the tax diversification part?” I asked. Steve asked me to imagine that our Gen-X couple eventually retires. They have over the years accumulated \$1 million in traditional IRAs and \$1 million in Roth IRAs.

“If taxes are high at the time they need the money, they can tap into their Roth and live off the tax-free money for awhile until tax rates come down. Or perhaps they can work themselves into a lower tax bracket. If taxes are relatively low, they can tap into their traditional IRA money and let the Roth keep growing tax-free. Creating a diversified retirement portfolio like this just gives them a lot more options. The

other plus is that there will never be any required minimum distributions from a Roth. There are, however, required minimum distributions (at age 70 1/2) for a traditional IRA. Could be that they will never need to tap the money in their Roth IRA and can pass it on to their heirs.”

“Ok, that’s all well and good. But how would this strategy apply to a Boomer couple? Use my husband and me as an example. We’ve been accumulating assets in traditional IRAs for years. If we were to convert our assets to a Roth in 2010, our tax bill on the dividends and earnings would be astronomical,” I said.

“This strategy may not be for everyone, but what you might want to do,” suggested Steve, “is to look at the amount of non-tax- sheltered money you might be able to make available in the year 2010. “Let’s say you’ll have \$80,000 left over after putting your kids through college. They get more merit scholarship money than you expected so that money is just sitting around in a liquid account.” “Ok, I like the sound of this already,” I chuckle. “You can work with your financial advisor to figure out how much of your traditional IRA you can convert to a Roth based on

your ability to pay the federal income taxes that will be due,” continues Steve. You could use the \$80,000 you have in savings to pay the tax bill.”

“Paying \$80,000 in taxes for that privilege makes me go weak in the knees,” I said. “Why would I want to do that? I’d rather buy land in Panama.” “Ok,” said Steve. “Figure out another way to buy that land in Panama. Then in 2010 convert as much of your portfolio to a Roth as you can afford, based on your potential tax liability. You and your husband are going to live longer in retirement than you may have ever expected. If you have a good chunk of money in a Roth and the rest in a traditional IRA, you’ll have the flexibility you need to make better choices based on your tax situation at any future point in time.”

“I’ll think about that,” I said as we shook hands and went our separate ways. Since that conversation, I’ve been googling around and playing with calculators that aim to tell us whether we should convert our traditional IRAs to a Roth. After plugging in our numbers and making some assumptions at <http://finance.yahoo.com/calculator/retirement/qua-04>, I was surprised to see that our projected after-tax income from our traditional IRA is significantly less (and I do mean significantly less) than our projected tax-free income if we were to convert all of our nest egg to a Roth in 2010. After I submit this article, I’m headed to the kitchen to talk with my husband about scheduling an appointment with our financial advisor.

My conversation with Steve Medland turned out to be a real eye-opener. What are you doing to open your clients’ eyes?

An award-winning columnist, Marie Swift has written the Focus on Financial Planning column for over three years. Read her blog, Best Practices in the Financial Services Industry, at www.marieswift.blogspot.com.

Traditional IRA vs. Roth – Income in Retirement

	Traditional IRA	Roth IRA
Contribution at 25% tax rate:	\$10,000	\$7,500
Account value in 20 years at 6%	\$32,071	\$24,054
If tax rates go DOWN in retirement e.g. 15% retirement tax rate	\$27,260	> \$24,054
If tax rates go UP in retirement e.g. 28% retirement tax rate	\$23,091	< \$24,054
If tax rates STAY THE SAME e.g. 25% retirement tax rate	\$24,054	= \$24,054