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Roth IRA Rollover / Conversion

Among its functions, the Roth IRA Rollover / Conversion utility:

- proposes an allocation between an existing IRA and a rollover (or conversion) to a Roth IRA based on objective analysis;

- performs a traditional analysis, based on provided tax rates and other specific information, or performs a more sophisticated risk analysis, basing the allocation on the probability of each type of plan out-performing the other;

- takes into account uncertainty regarding taxes, rates of return, and future withdrawals;

- calculates the effects of required minimum distributions on pre-tax money;

- determines eligibility for IRAs and Roth IRAs and calculates maximum permissible contributions to both.

This calculator is unusual in that, most of the time, rather than calculating a specific result, it calculates the risks involved in making one choice versus another.

It does this because, in the purest and simplest situation, where there is a fixed pattern of contributions and withdrawals and an unchanging tax rate, the ultimate after-tax effect of using pre-tax or after-tax contributions is exactly the same. But, of course, things do change, and so the two strategies will not, in reality, produce equal results. If we knew exactly how things were going to change, we could always place winning bets. But since we don't know, choosing between pre-tax and after-tax strategies remains something of a gamble.

When to Use This Calculator

The Roth IRA Rollover/Conversion calculator can be used any time someone is contemplating converting or rolling over a traditional IRA to a Roth IRA.

How to Use This Calculator

The calculator can, as previously mentioned, be used in either a sophisticated or a simpler mode. In either case, observing that the main input screen is divided into three sections, top to bottom, start at the top and work your way down. As you do so, various fields and options will be enabled or disabled, which will help guide you through the process. Use the detailed instructions that follow, or press the <F1> key at any time during the input process to obtain on-line Help.

When you have finished entering all the required information, use the "Print" menu to print or preview the results, or to export the data to an Excel spreadsheet (automatically named RothRoll.XLS).

Sophisticated (Monte Carlo) Analysis: Assumptions using +/- variances

In its most powerful mode, the calculator evaluates the odds of each strategy (pre-tax vs. Roth) out-performing the other, and suggests an allocation of contributions that corresponds to those odds. The way it performs the evaluation is by testing the results of thousands of randomly generated scenarios, and determining in each case which option did better, and by how much. But in order to have a reasonable way of generating plausible scenarios, the system requires the user to input not only the best guess about each input item, but the range of plausible values around the best guess.

The "+/-" entries indicate these ranges. The system requires that they be specified so that there is only about a one in twenty chance that reality will fall outside that range. (Technically, we will interpret the range as equal to two standard deviations, which is closer to one in twenty-two). This means that if you indicate a projected retirement age of 65 +/- 5 years, you are indicating that there is only about a one in twenty chance of retirement before age 60 or after age 70. The system will use this information to generate random retirement ages, mostly between 60 and 70, when it generates comparisons between pre-tax and after-tax contributions. The sample detail report produced as a result shows only one scenario, the one specified as most likely – in this example, using retirement age 65. But the suggested allocation between pre-tax and after-tax contributions is based on the combined results of all the scenarios tested.

What if you just want one scenario?

Delete all the "+/-" entries. Also, choose "Specified" in the "How are current and future tax brackets determined?" field. With this method, the system cannot really analyze the risk, so it determines the allocation by comparing the long-term results of each contribution strategy under the one scenario that you specify. But, in most cases, it will still suggest some split between the two options rather than allocating 100% to the fund that came out ahead in the illustration. You can disregard this suggestion, however, and contribute everything into one

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fund if you are extremely confident that the illustrated scenario will come true.

Resetting default values

The system provides its own default values for retirement age, rates of return, +/- variances, etc. You can create your own defaults by filling out these various items on the screen, then clicking the "Save Values as Defaults" button on the lower left of the screen.

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Detailed Input Instructions

Name

Enter the plan owner's name as it should appear on the printed report.

Date of birth (mm/dd/yyyy)

Enter the plan owner's date of birth in mm/dd/yyyy format. This field is required for all calculations.

How are current and future tax brackets determined?

Choose between one of the two options:

- **Calculated**. Select this option if you want the system to calculate federal income taxes using tax tables for each year. This method allows you to input data relating to current and future taxable income as well as information about inflation and other factors that might affect future tax rates. These items, except for current taxable income, are all subject to fluctuation in the course of the calculation, so that the actual future risk of higher or lower taxes can be modeled with reasonable accuracy. Since changes in tax brackets are one of the most important factors affecting the relative benefit of pre-tax and after-tax accounts, using this method is normally recommended since it recalculates each year what the approximate tax will be and uses more than one tax bracket in a given year when appropriate.

- **Specified**. Select this option if you want to specify a current marginal federal income tax rate that will be used for all years before retirement. You can also specify the post-retirement marginal federal tax rate, using a +/- variance, that will be used for all post-retirement years.

Year

Enter the calendar year (e.g. 2001) during which the Roth IRA rollover or conversion is to be made.

Tax Filing Status

This field is activated if "Calculated" is selected in the "How are current and future tax brackets determined?" field.

Select the correct filing status that the fund owner is expected to use on his or her federal income tax return. This field is important because the system will be performing tax calculations using actual or projected income tax rates which differ depending on filing status.

Current year taxable income (assuming no rollover/conversion)

This field is activated if "Calculated" is selected in the "How are current and future tax brackets determined?" field.

Enter the amount of ordinary taxable income (i.e. after deductions and exemptions) expected during the year being calculated. Include all ordinary income before the Roth IRA rollover or conversion is made. Do not include long-term capital gains or other income subject to special taxes.

It is important to make a reasonable guess at this value, even though the precise amount will seldom be known. Leaving it at zero will severely underestimate the taxes associated with the rollover and all future taxes.

Current state + local marginal tax rates

Enter the combined state and local marginal tax rate on ordinary income as a percentage (e.g. "3.5"). If the jurisdiction has a different rate for investment income than for income earned from salary or wages, use the investment income rate. If you do not want state and local taxes to be taken into account, leave this field blank.

The marginal rate is the rate at which the next dollar of income will be taxed, and is generally higher than the average rate at which income is taxed.

This calculator does not recalculate state and local income taxes at different income levels. If your state or locality has varying rates for different income levels, use the marginal tax rate applicable in the year the rollover is being made.

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Federal income tax marginal rate

This field is activated if "Specified" is selected in the "How are current and future tax brackets determined?" field.

Enter the current marginal federal income tax rate as a percentage (e.g. "28").

The marginal rate is the rate at which the next dollar of income will be taxed and is generally higher than the average rate at which income is taxed.

Total Social Security retirement benefits you are receiving this YEAR

This field is activated if, according to the date of birth entered, the plan owner is age 62 or older.

Enter the total amount of Social Security (or Railroad Retirement) benefits expected to be received during the year the IRA Roth rollover or conversion is to be made.

This information is requested because the additional taxable income generated by the IRA Roth rollover or conversion might increase the taxability of Social Security (or Railroad Retirement) income during the rollover/conversion year. In evaluating the rollover or conversion, the system will compute and take into account these additional taxes, if any.

Total balance of traditional IRA

Enter the total balance of the IRA account that can be rolled over or converted to a Roth IRA. You must always enter a value in this field in order to perform a calculation.

Please note: If there is a required minimum distribution that has not been made in the year of the rollover/conversion, this amount MUST be subtracted from the total balance to be rolled over or converted. Required minimum distribution amounts are not eligible for Roth IRA rollovers or conversions.

Amount contributed after-tax

Enter the amount of any prior IRA contributions (included in the "Total balance of traditional IRA") that were made on an after-tax basis. Such contributions receive more favorable tax treatment than deductible contributions or earnings on IRA contributions.

Tax to be paid out of pocket

Enter the amount of income tax on the rollover that you can pay out of pocket, rather than using money from the IRA account to cover the taxes.

The system will calculate and display the estimated tax due to the rollover/conversion as you enter data on the screen. It will also initially fill in the out-of-pocket amount for you by assuming you will pay all taxes out of pocket. If you enter an amount larger than the estimated tax, the system will reduce your entry to equal the tax. But once you enter a tax payment amount other than what the system calculates, the system will respect your input and leave it alone (as long as it is less than or equal to the estimated tax liability).

Please note that if you enter an amount lower than the estimated tax, indicating that the balance of the tax will be paid by IRA account funds, the estimated tax might actually increase. That is because for people under age 59½, there is a 10% penalty on funds withdrawn from an IRA and not rolled over. The more tax that is paid out of pocket, therefore, the better.

Retirement age or year

In the left hand field, enter the most likely retirement date as an age (e.g. "65") or year (e.g. "2020"). In the "+/-" field to the right, enter the range of probable variation in the retirement date.

Please specify the "+/-" range so that there is only about a one in twenty chance that reality will fall outside that range. (Technically, the system will interpret the range as equal to two standard deviations, which is closer to one in twenty-two.) This means that if you indicate a projected retirement age of 65 +/- 5 years, you are indicating that there is only about a one in twenty chance of retirement before age 60 or after age 70. The system will use this information to generate random retirement ages, mostly between ages 60 and 70, when it generates comparisons between pre-tax and after-tax accounts.

If you feel certain of the retirement age, or if you want the system not to vary the retirement age in testing different scenarios, leave the "+/-" field blank.

Post-retirement marginal federal income tax rate

This field is activated if "Specified" is selected in the "How are current and future tax brackets determined?" field.

In the left hand field, enter the most likely marginal income tax rate after retirement. For many people, tax brackets will be lower after retirement than before.

In the "+/-" field to the right, enter the range of probable variation in the income tax rate. If you feel certain of the tax rate, or do not want the system to vary the tax rate in testing different scenarios, leave the "+/-" field blank.

For more information, please refer to the on-line help for this field (click "F1" from this field).

Expected withdrawals

This field indicates some pattern of normal post-retirement withdrawals. Do not use this field to indicate Required Minimum Distributions, since these are calculated automatically by the system when appropriate.

Select from one of the five options:

- **No withdrawals (except as required by law).** Select this option to indicate that no voluntary withdrawals are anticipated. Note that use of this option will tend to result in a larger suggested allocation to the Roth IRA fund (other things being equal) since no withdrawals will be illustrated from that fund while Required Minimum Distributions will be illustrated from the pre-tax fund. The Required Minimum Distributions will then go into a side fund that is not tax-sheltered, and that therefore will tend to have less benefit.

- **Level annual dollar amounts.** Select this option to indicate you want to specify a level amount to come out of the fund at the beginning of each year. If you select this option, two fields below are activated in which you must input the starting withdrawal age or year and the annual amount to be withdrawn.

- **Increasing annual dollar amounts.** Select this option to indicate that you want to specify a certain amount to come out of the fund in the first year of withdrawal and annually thereafter increasing by a certain percentage each year. If you select this option, three fields below are activated in which you must input the starting withdrawal age or year, the initial amount to be withdrawn, and the annual percentage of increase.

- **Fixed percent of beginning-of-year balance.** Select this option to indicate that you want a fixed percentage of the beginning of year balance to be withdrawn each year. If you select this option, two fields below become activated in which you must input the starting withdrawal age or year and the annual percentage of beginning of year balance to be withdrawn.

- **Amortize over a fixed number of years.** Select this option to indicate that you want to amortize the pre-tax account balance over a specified number of years (using the post-retirement rate of return). If you select this option, two fields below become activated in which you must input the starting withdrawal age or year and the number of years over which the fund is to be amortized.

In the fields for dollar amounts, percentages, or years, use the left-hand box to enter the most likely value. In the "+/-" fields to the right, enter the range of probable variation.

Age or year when withdrawals begin

Enter the most likely starting withdrawal date as an age (e.g. "65") or a year (e.. "2020"). In the "+/-" box to the right, enter the range of probable variation.

Annual taxable withdrawal dollar amount

If you've chosen "Level annual dollar amounts" or "Increasing annual dollar amounts", enter the most likely dollar amount to be withdrawn in the first year. In the "+/-" box to the right, enter the range of probable variation.

Increasing each year by the following percentage

If you've chosen "Increasing annual dollar amounts", enter the most likely percentage by which annual withdrawals will increase. In the "+/-" box to the right, enter the range of probable variation.

Fixed percentage expected to be withdrawn each year

If you've chosen "Fixed percentage of beginning-of-year balance", enter the percentage of beginning of year balance to be withdrawn every year. In the "+/-" box to the right, enter the range of probable variation.

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Number of years over which to amortize withdrawals

If you've chosen "Amortize over a fixed number of years", enter the number of years over which to amortize the pre-tax fund. In the "+/-" box to the right, enter the range of probable variation.

Average annual rate of return AFTER retirement

Enter the most likely post-retirement average annual rate of return as a percent (e.g. "7.5"). In the "+/-" box to the right, enter the range of probable variation.

Average annual rate of return BEFORE retirement

Enter the most likely pre-retirement average annual rate of return as a percent (e.g. "7.5"). In the "+/-" box to the right, enter the range of probable variation.

Keep in mind for both "Average annual rate of return" fields that when specifying the +/- variance, this is the **average** rate of return. In many funds, annual returns may fluctuate wildly, but the average return over a long period of time is usually easier to predict and has a much smaller variance.

If you don't want the system to vary the rates of return in testing different scenarios, delete the "+/-" entries.

Chance of withdrawal within 5 yrs of first after-tax contrib.

Enter the likelihood, expressed as a percentage, that the funds will be withdrawn within five years of the first Roth IRA rollover.

If the individual has substantial non-qualified funds that could be used for large and/or unexpected cash needs, this value may also be "0", or close to it. For younger participants with changing lives and little savings, however, the odds of early withdrawal may be fairly high.

This information is required because a 10% penalty applies if Roth funds are withdrawn within five years of the Roth IRA rollover. If you indicate a likelihood greater than 50% in this field, the sample detail report will show a full withdrawal occuring in the fifth year.

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Open detail – BEST GUESS on future tax and income changes

If you click on the "Open detail" button, a gray panel with additional input items appears in the middle of the screen (see illustration, following).

This additional input is available only if you have selected "Calculated" in the "How are current and future tax brackets determined?" field.

Annual rate of growth in taxable income BEFORE retirement

Enter, as a percentage, the annual rate at which taxable income is expected to increase from the amount entered in the "Current year taxable income" field on the main screen until retirement age. A negative number indicates an annual decrease in taxable income. In the "+/-" box to the right, enter the range of probable variation.

Reduction in taxable income AT retirement

Enter the percentage by which taxable income is expected to decrease at retirement. A positive number means that at retirement, taxable income is expected to decrease by the indicated percentage. If taxable income is expected to increase at retirement (which is unusual, but it sometimes does happen), enter a negative number. In the "+/-" box to the right, enter the range of probable variation.

Annual rate of growth in taxable income AFTER retirement

Enter, as a percentage, the annual rate at which taxable income is expected to increase after retirement. An entry of "0" indicates a projection of flat retirement income. A negative number indicates an annual decrease in taxable income after retirement. In the "+/-" box to the right, enter the range of probable variation.

Please note that when estimating changes in taxable income, do not take into account income from the retirement plan being calculated. The system will add such amounts in, where necessary.

General inflation rate (to be applied to federal income tax tables)

Enter the most likely future average annual inflation rate as a percentage. In the "+/-" box to the right, enter the range of probable variation.

Your expectation about the long-term future trend of federal income tax rates

Click on one of the seven options, ranging from "Increase considerably" to "Decrease considerably".

A "slight" change means that current tax rates will be increased or decreased 10% over a 20 year period. For example, a 15% tax rate gradually becomes 16.5% or 13.5%, with an additional 10% variance around those targets, so that about 19 of 20 scenarios will show a 15% tax rate falling into the 15-18% range in 20 years if you indicate "Increase slightly", or the 12-15% range if you indicate "Decrease slightly".

A "moderate" change means that current tax rates will be increased or decreased 25% over a 20 year period. For example, a 15% tax rate gradually becomes 11.25% or

18.75%, with an additional 20% variance around those targets, so that about 19 out of 20 scenarios will show a 15% tax rate falling into the 15.75-21.75% range in 20 years if you indicate "Increase moderately, or the 8.25-14.25% range if you indicate "Decrease moderately".

A "considerable" change means that current tax rates will be increased or decreased 50% over a 20 year period. For example, a 15% tax rate gradually becomes 7.5% or 22.5%, with an additional 20% variance around those targets, so that abou 19 out of 20 scenarios will show a 15% tax rate falling into the 19.5-25.5% range in 20 years if you indicate "Increase considerably", or the 4.5-10.5% range if you indicate "Decrease considerably".

If you select "Stay about the same", there will be an average o% change in tax rates, but with a 10% variance, so that about 19 out of 20 scenarios will show a 15% tax rate falling into the 13.5-16.5% range in 20 years.

In all scenarios, tax rates remain flat after 20 years.

Note that these increases or decreases are in addition to any changes already mandated by law. The 2001 EGTRRA legislation specifies a gradual reduction in marginal tax rates, effective through 2010. The "Stay about the same" option, therefore, already represents a significant drop in future tax rates (and assumes they do not bounce back in 2011).

Participant's sex

Select "Male" or "Female" for the plan participant. Different mortality tables are used for males and females, since women, on average, live longer.

Smoking status

Select "Non-smoker", "Smoker", or "Unknown". Smoking status should be based on one's general past practice. If someone has recently quit after a long period of smoking, enter him or her as a "Smoker". Different mortality tables are used for smokers and non-smokers, since non-smokers, on average, live longer.

Dates of birth (mm/dd/yyyy) of plan beneficiary

Enter the date of birth only for the person, if any, who is the plan beneficiary and whose life expectancy will need to be taken into account when the system calculates required minimum distributions. If there is no beneficiary, and life expectancy is based on the plan participant alone, leave both dates of birth blank. If a spouse is the beneficiary, enter the spouse's date of birth and leave the other blank. If there is one or more non-spouse beneficiary, enter the date of birth of the oldest non-spouse beneficiary in the right hand box and leave the spouse date of birth blank.

Spouse smoking status

If you have entered a spouse beneficiary's date of birth in the preceding field, select the appropriate smoking status for the spouse beneficiary.

The purpose of the above four fields is to help the sytem estimate life expectancy. In the case of the plan participant, this is done so that an appropriate number of scenarios will show the plan ending (at least under the participant's ownership) before withdrawals or other events occur. In the case of a spouse beneficiary, it is so that appropriate adjustments can be made in the required minimum distributions if the spouse is projected to die first.