Roth Conversions

Finding the sweet spot

By Mike McGilligan

First, let me say I love Roth conversions. I think this is because, for most of my working career, I was denied access to them—either because they did not exist or because I was excluded due to income limits. I love them not just because they may save taxes (although I hope to demonstrate they can), but also because they provide for tax diversification. For each income need, I can choose whether to pay my effective marginal rate on a traditional IRA distribution, to pay no tax by withdrawing from a Roth or to pay some tax with a combination thereof.

On the other hand, I hate taxes that phase in (or out, or that involve cliffs) as they often result in discontinuity and confusion in the tax system. So, most of my time over the last few years as a tax preparer has been spent helping those in or near retirement navigate the tax structure and finding their "tax sweet spot," which often doubles as the Roth conversion sweet spot.

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Developing a tax strategy

Before looking for sweet spots, I want to spend a few minutes on tax strategy. First, we need to define the goal of tax strategy. Here are some options:

- Determine the distribution stream that provides the lowest total tax
- Determine the distribution stream with the lowest present value of tax
- Determine the distribution stream with the lowest average tax rate over the period

I prefer the last option because it doesn't depend on when I pay the tax or what discount rate I use.

However, when it comes to Roth conversions, there is a simpler way to compare strategies. I want to use the strategy that generates the largest Roth account at the end of the conversion period.

In Table 1, we look at a retired couple, both under age 65, who want to convert $1 million over a 15-year period. Here are the first six 2021 tax brackets for the above couple (assumes they take the standard deduction of $25,100). For this analysis, we are starting with the standard deduction of $25,100, which has a 0% tax rate. Also, we are showing the bottom of a range is equal to the top of the previous range so that the range calculation is simply the difference between the top and the bottom of the range.

Table 1: 2021 tax brackets, couple under 65, standard deduction			
Bottom	Top	Range	Rate Within Range
-	25,100	25,100	0%
25,100	45,000	19,900	10%
45,000	106,150	61,150	12%
106,150	197,850	91,700	22%
197,850	354,950	157,100	24%
354,950	443,950	89,000	32%

Let's look at how we might determine the best distribution/conversion strategy. The first step is to set a rate of return and number of years for the distribution. Table 2 shows a reasonable range of options.

In Tables 3 through 5 that follow, for comparison purposes, we are going to make the following simplifying assumptions:

- We are assuming no other income. (The impact of other income will be demonstrated later in the examples.)
- We are not indexing the tax brackets for inflation.
- We assume the tax rates within each bracket remain the same.

Table 2: Beginning balance 1,000,000			
Level annual conversion amounts (EOY) / period in years			
Assumed Rate of Return	10	15	20	25
0%	100,000	66,667	50,000	40,000
1%	105,582	72,124	55,415	45,407
2%	111,327	77,825	61,157	51,220
3%	117,231	83,767	67,216	57,428
4%	123,291	89,941	73,582	64,012
5%	129,505	96,342	80,243	70,952
6%	135,868	102,963	87,185	78,227
7%	142,378	109,795	94,393	85,811
8%	149,029	116,830	101,852	93,679

- Taxes on the conversion are paid from the conversion (generally you will want to pay the taxes from other funds, if possible).
- We'll be using a 15-year period and assuming a 4% annual rate of return. (Use the combination of years and rate of return most appropriate for the client.)

Table 3 shows the projection details for distributions/conversions over the 15-year period under our assumptions.

Table 3: Assumed asset return 4.00%					
Year	Assets BOY	Roth Conversion EOY	Marginal Rate	Tax on Roth	Roth Account EOY
1	1,000,000	89,941	12%	7,383	82,558
2	950,059	89,941	12%	7,383	168,418
3	898,120	89,941	12%	7,383	257,713
4	844,104	89,941	12%	7,383	350,580
5	787,927	89,941	12%	7,383	447,161
6	729,503	89,941	12%	7,383	547,606
7	668,742	89,941	12%	7,383	652,068
8	605,551	89,941	12%	7,383	760,709
9	539,832	89,941	12%	7,383	873,695
10	471,484	89,941	12%	7,383	991,201
11	400,402	89,941	12%	7,383	1,113,407
12	326,477	89,941	12%	7,383	1,240,502
13	249,595	89,941	12%	7,383	1,372,680
14	169,638	89,941	12%	7,383	1,510,145
15	86,483	89,942	12%	7,383	1,653,110
Totals	1,349,116			110,744	1,653,110
	Average tax rate		8.21%		

Assets BOY: Prior year amount increased by rate of return minus the distribution for the year

Roth conversion amount: Input for each year

Marginal rate: Rate applicable to last dollar of Roth conversion

Tax on distribution: Based on tax bracket table

Roth account: Prior year amount increased by rate of return plus after-tax Roth conversion for the year

Over the 15-year period, we've converted $1 million in pre-tax dollars to $1,653,000 in after-tax dollars. You'll note that, in this example, the tax is paid from the Roth conversion (generally, you want to pay the taxes from other funds, especially if the client is under age 59½). Again, when comparing options, the best option is the one where the Roth account is highest at the end of the period.

It may surprise you that we'll get the same Roth after-tax value using any strategy that keeps us in the 12% marginal tax bracket each year (that is, between $45,000 and $106,150). Note that these two amounts are our sweet spots (or more appropriately the sweet spot range in this case) — the tops of the 10% and 12% tax brackets.

Table 4 presents a forecast with conversions near the top of the 12% bracket in early years and near the bottom of the 12% bracket thereafter.

Table 4: Assumed asset return 4.00%				
Year	Assets BOY	Roth Conversion EOY	Marginal Rate	Tax on Roth	Roth Account EOY
1	1,000,000	106,000	12%	9,310	96,690
2	934,000	106,000	12%	9,310	197,248
3	865,360	106,000	12%	9,310	301,828
4	793,974	106,000	12%	9,310	410,591
5	719,733	106,000	12%	9,310	523,704
6	642,522	106,000	12%	9,310	641,342
7	562,223	106,000	12%	9,310	763,686
8	478,712	106,000	12%	9,310	890,924
9	391,860	106,000	12%	9,310	1,023,250
10	301,534	106,000	12%	9,310	1,160,870
11	207,595	45,000	12%	1,990	1,250,315
12	170,899	45,000	12%	1,990	1,343,338
13	132,735	45,000	12%	1,990	1,440,081
14	93,044	45,000	12%	1,990	1,540,695
15	51,766	53,837	12%	3,050	1,653,109
Totals		1,293,837		104,110	1,653,109
		Average tax rate	8.05%		

This strategy again converts $1 million into $1,653,000 after-tax dollars (although the average tax rate is slightly less). So which approach is better? The "more up front" approach has the following advantages:

- It provides for faster tax diversification.
- If you expect tax rates to go higher, it's better to convert to the top of the bracket in the early years.
- It protects against greater asset returns or RMDs, sending the client into a higher tax bracket later in the period.

- It reduces the likelihood that the surviving spouse will have problems with RMDs and/or Medicare premiums.

Any strategy where the marginal rate falls above or below 12% in any year or years will be suboptimal. An example is illustrated in Table 5.

Table 5: Assumed asset return 4.00%				
Year	Assets BOY	Roth Conversion EOY	Marginal Rate	Tax on Roth	Roth Account EOY
1	1,000,000	130,000	22%	14,575	115,425
2	910,000	130,000	22%	14,575	235,467
3	816,400	130,000	22%	14,575	360,311
4	719,056	130,000	22%	14,575	490,148
5	617,818	130,000	22%	14,575	625,179
6	512,531	130,000	22%	14,575	765,611
7	403,032	130,000	22%	14,575	911,661
8	289,153	130,000	22%	14,575	1,063,552
9	170,719	30,000	10%	490	1,135,604
10	147,548	30,000	10%	490	1,210,538
11	123,450	30,000	10%	490	1,288,470
12	98,388	30,000	10%	490	1,369,519
13	72,324	30,000	10%	490	1,453,809
14	45,217	30,000	10%	490	1,541,472
15	17,026	17,707	0%	-	1,620,838
Totals	1,237,707			119,540	1,620,838
		Average tax rate	9.66%		

You'll note that the average tax rate is 1.6% higher and the Roth balance is about $32,000 (2%) less. This is because in the first seven years, we are paying 22% on a portion of the conversion and in Year 9 through Year 15 we are not filling up the 10% tax bracket.

General Rule No. 1: In early years, the sweet spot is the top of the client's expected long-term marginal tax bracket. However, reduce the amount of conversion if/when it is anticipated that the marginal rate could drop to a lower tax bracket in later years.

Question: If I expect tax rates to go up over time, shouldn't I go into the next tax bracket for conversions now? **Answer:** It depends on the difference between the client's current bracket and the next bracket. I wouldn't want clients in the 12% bracket to pay 22% if I thought the 12% bracket might be increased to only 14%–16% (but I want them to get all the 12% money they can). I might be willing to consider a client currently in the 22% bracket going into the 24% bracket for a couple years if I thought the 22% bracket would be raised to 25%+.

How tax sweet spots can help reduce income tax liability

Now I'd like to move from a multi-year tax strategy to annual tax tactics. A client's tax sweet spot is defined as the level of income consisting of a specific combination of sources that is projected to give the best tax result (or Roth conversion result) over a two-year (or longer) period. Key considerations in determining the tax sweet spot for retirees include their Social Security income, tax filing status, tax-favored income and, for higher-income individuals, Medicare premiums. In some cases, state taxes can also be a significant factor.

For 2021 only, there could also be an issue with the third economic impact payment.

Social Security impact. Let's start by looking at the impact of Social Security benefits for our couple. The amount of Social Security subject to tax ranges from 0% to 85% depending on the amount of other income. This has a significant impact on the tax bracket. If other income is small, there is no impact. As IRA income increases, Social Security subject to tax is 50% of the extra income for a range and then goes to 85% of the extra income until the taxable Social Security reaches its maximum of 85%. Table 6 shows the possible effective marginal rates (or EMR for short).

Table 6: Social Security impact on EMRs

Base	50% Higher	85% Higher
0.0%	0.0%	0.0%
10.0%	15.0%	18.5%
12.0%	18.0%	22.2%
22.0%	33.0%	40.7%

We now have 10 possible EMRs — the original four rates plus rates that are 50% and 85% higher than the regular rates. The Social Security phase-in does not currently affect brackets higher than 22%.

You may notice I'm not showing the ranges applicable to these rates. That's because the ranges are no longer fixed — they depend on the amount of gross Social Security benefits for the year in question.

Table 7 shows the 2021 EMRs for annual Social Security benefits of $12,000, $24,000, $36,000 and $48,000. The rates shown are the average rate for each $4,000 increment in IRA income. For rates that don't match one of the 10 possibilities, it simply means that the $4,000 range straddles two brackets.

Table 7: 2021 effective marginal rates

	Married couple under age 65				
		Annual Social Security benefits			
IRA Distribution	None	12,000	24,000	36,000	48,000
-	0.0%	0.0%	0.0%	0.0%	0.0%
4,000	0.0%	0.0%	0.0%	0.0%	0.0%
8,000	0.0%	0.0%	0.0%	0.0%	0.0%
12,000	0.0%	0.0%	0.0%	0.0%	0.0%
16,000	0.0%	0.0%	0.0%	0.0%	0.0%
20,000	0.0%	0.0%	0.0%	0.0%	2.3%
24,000	0.0%	0.0%	2.3%	9.8%	18.5%
28,000	7.3%	9.8%	15.0%	16.8%	18.5%
32,000	10.0%	15.0%	15.0%	18.5%	20.1%
36,000	10.0%	15.0%	18.7%	21.3%	22.2%
40,000	10.0%	18.1%	22.2%	22.2%	22.2%
44,000	10.0%	19.5%	22.2%	22.2%	22.2%
48,000	11.5%	12.0%	22.2%	22.2%	22.2%
52,000	12.0%	12.0%	14.4%	22.2%	22.2%
56,000	12.0%	12.0%	12.0%	19.5%	22.2%
60,000	12.0%	12.0%	12.0%	12.0%	22.2%
64,000	12.0%	12.0%	12.0%	12.0%	14.4%
68,000	12.0%	12.0%	12.0%	12.0%	18.6%
72,000	12.0%	12.0%	12.0%	12.0%	22.0%
76,000	12.0%	12.0%	12.0%	13.1%	22.0%
80,000	12.0%	12.0%	12.0%	22.0%	22.0%
84,000	12.0%	12.0%	12.0%	22.0%	22.0%
88,000	12.0%	12.0%	17.6%	22.0%	22.0%
92,000	12.0%	12.0%	22.0%	22.0%	22.0%
96,000	12.0%	12.1%	22.0%	22.0%	22.0%
100,000	12.0%	22.0%	22.0%	22.0%	22.0%
104,000	12.0%	22.0%	22.0%	22.0%	22.0%
108,000	16.6%	22.0%	22.0%	22.0%	22.0%
112,000	22.0%	22.0%	22.0%	22.0%	22.0%
116,000	22.0%	22.0%	22.0%	22.0%	22.0%
120,000	22.0%	22.0%	22.0%	22.0%	22.0%

The green highlighted cells show the period during which the phase-in occurs. We get EMRs that increase, then decline (because Social Security is fully phased in), then increase again.

You'll note that the higher the Social Security, the longer the period for the higher rates.

Tax-favored income: qualified dividends and long-term capital gains. For clients with significant qualified dividends or long-term capital gains, Roth conversion will generate a bump when the conversions push the favored income from a 0% bracket to the 15% bracket. For example, the EMR will change from the 12% bracket to a 27% bracket until all the capital

gains reach the 15% bracket, then the EMR will drop to 22%. Table 8 illustrates this impact.

Table 8: Impact of qualified dividends on EMR

Assumptions
Status: Married
Social Security: None
Qualified dividends/CG: 12,000

IRA Income	Federal AGI	Effective Marginal Rate
52,000	64,000	12.0%
56,000	68,000	12.0%
60,000	72,000	12.0%
64,000	76,000	12.0%
68,000	80,000	12.0%
72,000	84,000	12.0%
76,000	88,000	12.0%
80,000	92,000	12.0%
84,000	96,000	12.0%
88,000	100,000	12.0%
92,000	104,000	12.0%
96,000	108,000	* 18.9%
100,000	112,000	* 27.0%
104,000	116,000	* 27.0%
108,000	120,000	* 24.7%
112,000	124,000	22.0%
116,000	128,000	22.0%
120,000	132,000	22.0%
124,000	136,000	22.0%

* Qualified dividends move from 0% to 15% bracket

Medicare income-related premiums. In addition to Social Security phase-ins and tax-favored income, Medicare income-related premiums can also affect the sweet spots. Medicare premiums are often referred to as "cliff" premiums since going even one dollar above the threshold requires hundreds of dollars in extra annual premiums. Table 9 at the bottom of the page shows the 2021 Medicare premiums by filing status and modified adjusted gross income (MAGI).

Because Medicare costs for 2021 premiums are set in late 2020, MAGI figures are used from 2019 tax returns (that is, the prior year), as these were the returns that were most recently available before the beginning of 2021.

You may also notice that there is little encouragement for couples to file separately unless the MAGI is less than or equal to the baseline amount of $88,000. The extra dollar over this amount sends you directly to level four premiums which are $4,769 ($6,551 - $1,782) higher per affected person than the baseline premiums.

Even though these extra premiums are not technically taxes, and there is a two-year deferral of payment (relative to when the dollars were earned), it's helpful for the analysis to assign a tax rate to them. The 2021 level one annual premium is $860 more than the baseline annual premium, equivalent to an 86% effective tax if we only go $1,000 into the bracket.

Table 9: 2021 Medicare premiums

Level	2019 Single Individual MAGI	2019 Married Filing Jointly MAGI	2019 Married Filing Separately MAGI	Annual Part B Cost Per Person	Annual Part D Surcharge Per Person	Total 2021 Medicare Premiums Per Person	* Medicare Tax Marginal Cost
Baseline	<=$88,000	<=$176,000	<=$88,000	$1,782.00	$-	$1,782.00	N/A
1	$88,001 to $111,000	$176,001 to $222,000	N/A	$2,494.80	$147.60	$2,642.40	1.9%
2	$111,001 to $138,000	$222,001 to $276,000	N/A	$3,564.00	$381.60	$3,945.60	2.4%
3	$138,001 to $165,000	$276,001 to $330,000	N/A	$4,633.20	$614.40	$5,247.60	2.4%
4	$165,001 to $499,999	$330,001 to $749,999	$88,001 to $411,999	$5,702.40	$848.40	$6,550.80	0.3%
5	>= $500,000	>= $750,000	>= $412,000	$6,058.80	$925.20	$6,984.00	

MAGI is adjusted gross income plus tax-exempt interest income
* Married filing jointly per person

However, we want to employ the "Price is Right" rule (that is, get as close to the top of the range as possible without going over). The average effective tax for an MFJ taxpayer would be $860 [(difference in total premium between baseline and level one) ÷ $46,000 (the width of the level one MAGI bracket)] or 1.9% per person. If both are affected, the premium expenses are doubled, and an overall marginal increase of 3.8% would apply to the couple.

Let's look at an example combining all three items. In Example 1, Jack and Jill are both age 63 (therefore subject to Medicare issues two years hence) and the combined Social Security is $36,000 ($12,000 for Jack and $24,000 for Jill). They also own stocks, which generate $12,000 a year in qualified dividends. Table 10 on page 45 shows the impact on effective marginal rates for IRA distributions at $4,000 intervals.

- Column 1 shows the IRA income in $4,000 intervals
- Column 2 shows the phase-in of Social Security taxation (shaded in gray) until it reaches $30,600 (85% of the $36,000)
- Column 3 shows the federal AGI
- Column 4 shows taxable income (that is, AGI less the standard deduction)
- Column 5 shows the federal tax
- Column 6 shows the EMR for the $4,000 interval

Bumps in the EMR occur during the Social Security phase-in and again between $64,000 and $76,000 when extra IRA distributions push the EMR to 27% (12% regular bracket plus 15% for the qualified dividends as they get pushed from a tax rate of 0% to 15%).

At the bottom of the example, I have summarized the key items from the ranges where the top of the range is highlighted in green (sweet spots) or orange (bad spots). The total cost is the total tax for a distribution at the top of the range. The EMR for an IRA range is the difference in total cost between ranges divided by the width of the range. You'll note that the $44,000 row has been labeled a bad spot. That's because they should never take a distribution at that level. Here's why.

The $28,000 distribution between $16,000 and $44,000 costs them 20% in taxes or $5,542. But the next $20,000 is on sale. They can get the amount between $44,000 and $64,000 at 12% — a tax cost of $2,468 ($8,010 - $5,542). Unfortunately, they have to pay the 20% rates to get to the 12% range. But they don't have to do that every year. They can take $64,000 in Year 1 and $24,000 in Year 2 (total $88,000) and pay taxes of $9,350 over the two years. Compare that with taxes of $11,084 over two years on annual distributions

of $44,000. This amounts to a savings of about $1,700 over the two-year period (or 15% of the tax paid).

Similarly, they should never take a distribution at $76,000, since a combination of $88,000 one year and $64,000 the next will give a lower tax since they're only paying the 27% once every two years. However, in this case there is an even better strategy. They could take $132,000 (being careful not to exceed the Medicare income limit) in Year 1 (doing a Roth for the amount above $76,000) and take $64,000 over the next four years, thereby paying the 27% only once every five years.

General Rule No. 2: When you have a bracket of income that has a lower EMR than the previous income bracket, never take a distribution at (or near) the top of the higher-taxed bracket. You should go to the top of the lower-taxed bracket (or at least into the bracket for a range equal to the range of the previous bracket). Distributions should be at the sweet spot above your long-term distribution expectation until that expectation drops to the next lower sweet spot.

Filing status impact

Up to now, we've focused on a married couple filing jointly. Example 2 on page 46 shows the EMRs for Jill as a single person age 63 with a Social Security benefit of $24,000. Here we see the dreaded 40.7% EMR for the first time. This is because Social Security is still phasing in at 85% when the income reaches the 22% bracket (1.85 x 22% = 40.7%). Because the qualified dividends come in at the same time, the marginal rates reach 50% (1.85 x 27% = 49.95%) for some intervals. Also note there is now no drop to the 12% bracket, meaning the top of the 22.2% EMR is no longer a bad spot (because it's followed by a higher rather than lower EMR). It's neutral or possibly even a sweet spot, depending on the expected level long-term income.

In this case, we want to find a way to pay the 40.7% (50% because of the qualified dividends) rate as few times as possible. If we're targeting IRA income of $32,000 a year (tax cost of $12,564 over two years), we can lower our cost by alternating between $40,000 and $24,000 tax cost of $11,219 ($8,076 + $3,143), which is a tax savings of about $670 per year.

We said before we normally want to go to the top of the lower EMR bracket (in this case Medicare). In this case, a four-year strategy would be appropriate because the width of the Medicare is almost triple the width of the 40.7% bracket. If we do a four-year strategy, we'll save about $1,000 per year because we are only incurring the full 40% range once every four years.

Table 10: Jack and Jill (Example 1)

Assumptions:

Status	Social Security	Qual Div/CG	Medicare	State
Married	36,000	12,000	Yes	N/A

IRA Income	Taxable Social Security	Federal AGI	Federal Taxable Income	Federal Tax	Effective Marginal Rate	Comment
-	-	12,000	-	-	0.0%	
4,000	1,000	17,000	-	-	0.0%	
8,000	3,000	23,000	-	-	0.0%	
12,000	5,000	29,000	3,900	-	0.0%	
16,000	7,700	35,700	10,600	-	0.0%	**No tax**
20,000	11,100	43,100	18,000	600	15.0%	
24,000	14,500	50,500	25,400	1,340	18.5%	
28,000	17,900	57,900	32,800	2,098	19.0%	
32,000	21,300	65,300	40,200	2,986	22.2%	
36,000	24,700	72,700	47,600	3,874	22.2%	
40,000	28,100	80,100	55,000	4,762	22.2%	
44,000	30,600	86,600	61,500	5,542	19.5%	**Top of 22.2%**
48,000	30,600	90,600	65,500	6,022	12.0%	
52,000	30,600	94,600	69,500	6,502	12.0%	
56,000	30,600	98,600	73,500	6,982	12.0%	
60,000	30,600	102,600	77,500	7,462	12.0%	
64,000	30,600	106,600	81,500	8,010	13.7%	**Top of 12%**
68,000	30,600	110,600	85,500	9,090	27.0%	
72,000	30,600	114,600	89,500	10,170	27.0%	
76,000	30,600	118,600	93,500	11,227	26.4%	**Qualified Dividends**
80,000	30,600	122,600	97,500	12,107	22.0%	
84,000	30,600	126,600	101,500	12,987	22.0%	
88,000	30,600	130,600	105,500	13,867	22.0%	
92,000	30,600	134,600	109,500	14,747	22.0%	
96,000	30,600	138,600	113,500	15,627	22.0%	
100,000	30,600	142,600	117,500	16,507	22.0%	
104,000	30,600	146,600	121,500	17,387	22.0%	
108,000	30,600	150,600	125,500	18,267	22.0%	
112,000	30,600	154,600	129,500	19,147	22.0%	
116,000	30,600	158,600	133,500	20,027	22.0%	
120,000	30,600	162,600	137,500	20,907	22.0%	
124,000	30,600	166,600	141,500	21,787	22.0%	
128,000	30,600	170,600	145,500	22,667	22.0%	
132,000	30,600	174,600	149,500	23,547	22.0%	**Medicare**

IRA Range			Total Cost	EMR in Range		Comment
$-	to	**$16,000**	$-	0%		Top of 0%
$16,000	to	**$44,000**	5,542	20%		Top of 22.2%
$44,000	to	**$64,000**	8,010	12%		Top of 12%
$64,000	to	**$76,000**	11,227	27%		Qualified dividends
$76,000	to	**$132,000**	23,547	22%		Medicare base limit

Green = Sweet Spot
Orange = Bad Spot

Table 11: Jill only (Example 2)

Assumptions:					
Status		Social Security	Qual Div/CG	Medicare	State
Single		24,000	12,000	Yes	N/A

IRA Income	Taxable Social Security	Federal AGI	Federal Taxable Income	Federal Tax	Effective Marginal Rate	Comment
-	-	12,000	-	-	0.0%	
2,000	500	14,500	1,950	-	0.0%	
4,000	1,500	17,500	4,950	-	0.0%	
6,000	2,500	20,500	7,950	-	0.0%	
8,000	3,500	23,500	10,950	-	0.0%	
10,000	4,500	26,500	13,950	195	9.8%	Low tax
12,000	6,200	30,200	17,650	565	18.5%	
14,000	7,900	33,900	21,350	935	18.5%	
16,000	9,600	37,600	25,050	1,367	21.6%	
18,000	11,300	41,300	28,750	1,811	22.2%	
20,000	13,000	45,000	32,450	2,255	22.2%	
22,000	14,700	48,700	36,150	2,699	22.2%	
24,000	16,400	52,400	39,850	3,143	22.2%	Top of 22.2%
26,000	18,100	56,100	43,550	4,041	44.9%	
28,000	19,800	59,800	47,250	5,040	50.0%	
30,000	20,400	62,400	49,850	5,742	35.1%	
32,000	20,400	64,400	51,850	6,282	27.0%	40.7% /Qual div
34,000	20,400	66,400	53,850	6,756	23.7%	
36,000	20,400	68,400	55,850	7,196	22.0%	
38,000	20,400	70,400	57,850	7,636	22.0%	
40,000	20,400	72,400	59,850	8,076	22.0%	
42,000	20,400	74,400	61,850	8,516	22.0%	
44,000	20,400	76,400	63,850	8,956	22.0%	
46,000	20,400	78,400	65,850	9,396	22.0%	
48,000	20,400	80,400	67,850	9,836	22.0%	
50,000	20,400	82,400	69,850	10,276	22.0%	
52,000	20,400	84,400	71,850	10,716	22.0%	
54,000	20,400	86,400	73,850	11,156	22.0%	Medicare
56,000	20,400	88,400	75,850	11,596	22.0%	
58,000	20,400	90,400	77,850	12,036	22.0%	
60,000	20,400	92,400	79,850	12,476	22.0%	
62,000	20,400	94,400	81,850	12,916	22.0%	

IRA Range			Total Cost	EMR in Range	Comment
$-	to	**$10,000**	195	2%	Top of 0%
$10,000	to	**$24,000**	3,143	21%	Top of 22.2%
$24,000	to	**$32,000**	6,282	39%	Top of 40.7%/Qual div
$32,000	to	**$54,000**	11,156	22%	Medicare base

Green = Sweet Spot
Orange = Bad Spot
Blue = Neutral

Example 2, Jill only, illustrates that EMRs are typically more of a problem for single individuals (see Table 11 on page 46). The problem is exacerbated for surviving spouses because income typically only drops due to the elimination of the lower Social Security benefit. This often results in a higher tax bracket (EMR) than when married and a higher likelihood of increased Medicare premiums.

State tax issues

In many cases, state taxes can be ignored in the analysis (that is, they will not affect the sweet spot determination), especially if the state has a flat rate (or it becomes a flat rate at a low level of income). However, some states can also exhibit the up and down tax rate phenomenon on EMRs, usually due to how the state handles Social Security. The good news is, according to Kiplinger, there are only 13 states that tax Social Security. Table 12 below summarizes these states and my estimate of how severe the impact would be on tax tactics. In any case, you should consult with a tax professional familiar with the client's state of residency because many states also allow a limited exclusion for other types of retirement income.

The states marked "Cliff" would act more like Medicare premiums where you will want to go to a sweet spot after the cliff for some limited period and then move to a sweet spot below the cliff for as many years as possible.

I should also point out that for those states where the married filing separately (MFS) threshold is more than 50% of the married filing jointly (MFJ) threshold (for example, Connecticut, Missouri, Nebraska, Rhode Island, Vermont), you may be able to file separately

Table 12: State tax summary (for those taxing Social Security)				
State	Range of Tax Rates Likely to be Impacted	Social Security	Type of Impact	Impact on Sweet Spots
Colorado	Flat 4.55%	Up to $24,000 excluded		Not likely
Connecticut	5% to 6%	Full exclusion if AGI less than $100,000 ($75,000 if single or MFS), otherwise 75% exclusion	Cliff	Modest impact
Kansas	5.25% to 5.75%	Full exclusion if AGI less than $75,000, otherwise full inclusion	Cliff	Significant at low to moderate income levels
Minnesota	6.80% to 7.85%	Partial exclusion up to $5,240, if income is $79,480 or lower	Phase-out rate 20%	Modest impact at moderate income levels
Missouri	5.40%	Full exclusion if AGI less than $100,000 ($85,000 if single or MFS)	Phase-out rate dollar for dollar	Doubles tax rate until phased out
Montana	6.90%	Separate worksheet required		Unknown
Nebraska	5.01% to 6.84%	Full exclusion if income less than $59,100 ($44,460 for single or MFS)	Cliff	Significant at lower income levels
New Mexico	4.90%	Social Security benefits taxed same as federal		Increases the hump, but sweet spots likely remain the same
North Dakota	2.04% to 2.27%	Full exclusion if AGI less than $100,000 ($50,000 for single or MFS)	Cliff	Moderate because of low tax rates
Rhode Island	3.75% to 5.99%	Full exclusion if AGI less than $106,400 ($85,150 for single or MFS)	Cliff	Significant
Utah	4.95%	Social Security benefits taxed same as federal		Increases the hump, but sweet spots likely remain the same
Vermont	3.35% to 7.60%	Full exclusion if AGI less than $60,000 ($45,000 for single or MFS)	Phases out over $10,000	Significant at moderate income levels
West Virginia	4.5% to 6.5%	Full exclusion (2021 and later) if AGI less than $100,000 ($50,000 for single or MFS)	Cliff	Significant

Note: This chart should be viewed as a rough outline based on the sources shown below. There could be other provisions that have a greater impact on the effective marginal rates. Consult with a tax professional who works in those states.

Sources: Kiplinger Tax Letter and The Tax Book

and convert more income and save significant state taxes. You just need to make sure the income for each spouse does not exceed $88,000 if they are within two years of Medicare eligibility.

Economic impact payment in 2021 (EIP3)

For clients who have been converting to the Medicare base level amount, 2021 would be a good year to drop down to a maximum AGI of $150,000. The federal tax cost to go from the $150,000 threshold to $175,000 is 33% (22% tax rate plus loss of $2,800 in EIP).

Timing of conversions

I prepare a chart like Examples 1 or 2 for clients who are in or near retirement when I prepare their tax returns. In most cases, it's the only valuable information I give them since it's usually too late to change their taxes for the previous year. I identify their sweet spot for the coming year and let them know the tax cost of exceeding it.

I generally recommend Roth conversions near the end of the year, especially if mutual funds are held in taxable accounts. I've had a few clients who were surprised by higher-than-anticipated capital gain distributions after the conversion was done, which also resulted in higher Medicare premiums.

Occasionally, I will suggest partial conversions earlier in the year if there is a strong perception that the market is below fair value due to a temporary event (for example, Covid).

Summary

A sweet spot is generally found at the top of a bracket of income that has an effective marginal rate that is lower than the EMR for the next following bracket of income. Conversely, bad spots are found at the top of a bracket that has an EMR that is higher than the next bracket.

EMRs (and, therefore, sweet spots) are affected by tax code provisions that cause bumps or discontinuities in "regular" tax rates. Examples include:
- Phase-in of Social Security benefits subject to tax
- Differing rates and schedules apply to different types of income (for example, ordinary income versus tax-favored income, net investment income tax)
- Tax credits that phase in or phase out (for example, child tax credits, education credits, qualified business income deductions)

- Costs outside the tax code that depend on income (for example, ACA contributions, Medicare income-related premiums)
- State tax provisions that generate temporary bumps in rates

Roth conversions should generally be done using the sweet spots above and below the projected long-term annual income. I believe the best strategy is to convert at the sweet spot above the annual expected level income amount each year until a new calculation of annual income would suggest you move to the lower sweet spot. The main idea is to pay the "bump" price in as few years as possible.

To ensure that the client has not moved (either up or down) to a different long-term tax bracket, the sweet spots should be reviewed every two to five years (or whenever there is a change in income or credits that can cause bumps).

I sometimes imagine a world with just one set of tax brackets that applies to all taxable income, one where:
- Tax credits are available only for items we really want to support, and any phaseout of the credit would be spread so the impact on a tax bracket would be no more than 1-2% (for example, a $2,000 credit would be phased out over at least $100,000 in income).
- Medicare Extra annual premiums would equal 1% of income above a threshold of say $200,000.
- If we want tax-favored treatment for some items, it would be done by including only a percentage in taxable income (for example, 40% of capital gains would be taxable, 50% of Social Security would be taxable).
- Ordinary income doesn't affect the amount of capital gains subject to tax and neither affects the amount of Social Security subject to tax.

I'd never have to worry about the effective marginal rate declining as income increased, Roth conversions would be simple and I could die a happy man. ▶

About the author

Mike McGilligan is a tax preparer (formerly an RTRP who is now an AFSP) in Missouri who focuses on helping moderate income retirees manage their retirement income in a tax-effective manner. In a prior life, he spent 25 years as an enrolled actuary specializing in helping large employers manage their retirement programs. Currently, Mike is gently phasing into retirement.