Why State Taxes Make Roth Conversion a Huge Opportunity for Americans Abroad

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Summary

This note analyzes how the exemption from state income taxation enjoyed by most Americans abroad significantly alters the calculation that determines whether or not Roth contributions and/or Roth conversion make financial sense. It concludes that the exemption from state taxes makes Roth conversion an especially attractive financial opportunity for Americans abroad that should be capitalized on while they are still living outside the U.S.

Introduction

Even under the most conventional of circumstances, American taxpayers struggle to fully understand the myriad of tax advantaged retirement investment options they have. IRAs, 401(k)s, Roths, Individual 401(k)s, 403(b)s, 527s, and defined benefit employer pension plans are some of the many possible investment account choices from which American taxpayers must commonly choose. Each has different tax implications and a separate set of complex compliance rules, contribution limits, mandatory withdrawal requirements and other features. Being an American abroad, however, further complicates matters by layering on additional tax and planning complexities. The good news is that Americans abroad generally

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have the same opportunities as do Americans at home to accrue tax benefits from tax advantaged accounts. In fact, under certain circumstances and with proper planning, expats may gain more than most from the proper employment of these accounts.

To help Americans abroad sort out the financial complexities of retirement, Thun Financial is publishing a series of notes addressing key issues in retirement planning. The first note, ***IRAs, Roth IRAs and the 2010 Conversion Decision for Americans Abroad*** (December, 2009; available at www.thunfinancial.com) addressed three broad issues:

1) The basic differences between traditional IRAs and Roth IRAs (see Appendix A); 2) the 2010 tax law changes that expand eligibility for Roth treatment (see Appendix B); 3) the Roth conversion/contribution calculation given special expat circumstances. A key conclusion of that research was that Roth conversion and Roth contributions make sound financial sense when tax rates in retirement are expected to be as high as or higher than they are now. The note then analyzed many of the key considerations that must be made when estimating future tax rates. To simplify matters, we ignored state taxes because the state tax rate presumably applies at the time of contribution as well as in retirement. But that assumption does not hold for most American expats. And this critical difference can often sway the outcome of the calculation in favor of conversion. As we will explain below, the Roth IRA permits many expats who will return to the United States and retire there to receive large amounts of income free from state taxation both while they are abroad and permanently shelter that income and earnings on that income from state taxation.

How Do Roth Accounts Work?

We start with a brief refresher on how Roth works. Contributions to Roth accounts are not tax deductible in the year of the contribution and therefore provide no immediate tax benefit. In contrast, contributions to other traditional retirement accounts (401ks, IRAs, etc.) reduce taxable income by the amount of the contribution in the year the contribution is made and hence provide an immediate tax benefit. It is important to remember, however, that this tax benefit is merely a deferral of the tax: when the accounts are drawn down in retirement, all withdrawals are fully taxable. The advantage of Roth accounts are that earnings (interesting, dividends and capital gains) are not taxed when withdrawn, and hence are forever tax free, not just tax deferred. Therefore, when choosing Roth over a traditional retirement account, the effective trade off is to give up tax deferral on contributions and earnings in favor of tax-exempt on earnings. So, what is the more valuable tax benefit, tax-deferral on the whole account or tax-exemption on earnings? Well, as we discussed in great detail in the first article of this series, the answer depends on many variables. But those variables can be distilled down in to one simple rule of thumb: choose Roth if you expect your tax rate in retirement to be as high as or higher than your current tax rate. So how do we know what our retirement tax rate will be?

State Taxes: the Impact on Current and Future Tax Rates when Living Abroad

While we know our current tax rate, forecasting future tax rates depends on many difficult-to-forecast variables. This issue was discussed extensively in the first article in this series. Nevertheless, in that discussion we disregarded one key consideration: state taxation. We did so because for most Americans, the state tax rate makes no difference to the outcome of Roth contribution/conversion calculation because in most cases the change in state tax rates between working years and retirement years will mirror changes in federal tax rates. That is to say that if your financial situation is such that you expect your federal tax rate to be lower or higher in retirement than it is during your working years, you can expect the same for state tax rates. But for Americans living abroad this assumption does not hold because most Americans abroad can escape paying state taxes for the time that they are living abroad. As a result, when we factor in state taxes across the whole life cycle for Americans currently living abroad, we most frequently find that future tax rates (federal + state) are likely to be higher than current tax rates (federal only), even in cases where federal tax rates in retirement decline along with income. And as explained earlier, when future tax rates are as high as or higher than current tax rates, Roth conversion is usually the right choice. Therefore, a full elaboration of the Roth conversion calculation that includes an analysis of state tax rates will frequently tip the scales in favor of contributing to and/or converting to a Roth (see Appendix D for a table of state tax rates).

Example: the Jones Family

To illustrate this concept, we describe the hypothetical case of the Jones family who move from New York to Singapore. They plan to stay in Singapore for five years and then return permanently to California. Ms. Jones works as a software engineer and earns approximately $250,000 a year while Mr. Jones stays home and takes care of the kids for the years they are abroad. Their combined taxable income (disregarding the Foreign Earned Income Tax Exclusion) is about $224,000, putting them in the marginal federal income tax bracket of 33%. They expect to retire when they are 65, stay in California, and live off of a combination of investment income (interest, dividend and capital gains), IRA distributions, and social security. They estimate their total retirement income will be about $132,000 a year and their federally taxable income will be approximately $113,300. Their retirement federal marginal tax bracket would be 25%. In this example, basing an analysis only on federal tax rates, it would appear that the Jones should choose traditional IRA contributions over Roth IRA and should not convert their traditional IRA assets at this time because their current marginal tax rate is a full 8% higher than their estimated retirement marginal tax rate. Now, however, let's factor in state taxes. Since the Jones' intend to retire in California, they can expect to pay a state income tax at a marginal rate of 9.3% during their retirement years (even though California does not tax social security benefits). If they were currently living in California, their California state margin tax rate would also be 9.3% and it would not change the analysis: their

all-in (state+ federal) current marginal tax rate would still be about 8% higher than their projected all-in retirement marginal tax rate and therefore Roth contributions and Roth conversion would be unwarranted. *However, they do not live in California. They live in Singapore now and will be subject to California state tax only upon their return to the U.S.* Therefore, their all-in current marginal tax rate consists only of their federal rate while their retirement all-in marginal tax rate will consist of their federal and state tax rates. This analysis yields a current marginal tax rate of 33% (federal) versus 34% in retirement (25% federal + 9% state). Thus, including state taxes in the analysis yields a retirement tax rate projected to be 1% greater than current tax rates versus 8% less when state taxes were ignored. Since the all-in marginal tax rate in retirement is expected to be higher than their current tax rate Roth contribution and conversion may indeed be a wise current strategy for the Jones.

Other Factors to Consider

The hypothetical Jones family example is a clear case where living abroad creates a great planning opportunity to take advantage of Roth contributions and even conversion before returning to the U.S. State taxes, however, can themselves be hard to forecast.

Where will you retire?

The biggest issue is considering the tax rate of the state in which you expect to retire (see Appendix D for a list of state tax rates). If you plan to retire in Florida, or one of the other six states with no income tax, then state tax analysis will have no impact on the Roth conversion calculation. If you expect to retire in one of the states with a relatively low income tax rate, such as Illinois, the role of state taxes may tip the scale in favor on Roth, or it may not. If you expect to retire in a high tax state such as California, New York or Oregon, there is a high likelihood that the inclusion of state taxes into the Roth calculation will yield a recommendation to employ Roth, if that conclusion was not clear already simply based on analysis of federal tax rates. And, of course, if you intend to retire abroad, then state taxation is again not to be factored at all.

Changing Tax Policies

With the expiration of the Bush tax cuts schedule for 2011, Federal tax rates are already set to rise (see Appendix C). That fact alone skews the analysis towards Roth conversion now, while rates are still low. Furthermore, federal and state fiscal crises are so obviously looming just over the horizon that it is fairly certain that future tax rates will be higher still. This general expectation needs to be built into realistic estimates of future tax rates. It is another strong factor in favor of Roth contribution and conversion now.

Tax Diversification

For many younger taxpayers or the merely moderately well-off, making a close to definitive conclusion about whether conversion is financially optimal may not be possible. There can be too many uncertainties about retirement year financial circumstances to make an accurate estimate of applicable future tax rates. This is one of the reasons that taxpayers may want to pursue a strategy of “tax

diversification." In this scenario, taxpayers split retirement accounts between Roth and traditional. This approach effectively hedges the taxpayer against the risk of being in a much higher or lower marginal tax bracket during retirement than they anticipated when they made the decision between traditional and Roth. Tax diversification makes especially good sense for Americans abroad because the complexity of the conversion calculation is augmented by their special tax and planning circumstances.

Conclusion

Making the right decision about Roth conversion requires a high degree of analytical rigor. Many factors have to be included in the equation. For Americans abroad, a full accounting of the impact of states taxes is a key variable that in many cases (but not all) will sway the analysis in favor of the Roth option. Roth accounts provide an opportunity for Americans abroad to fully and permanently shelter income from state taxes. This benefit alone may portend hundreds of thousands of dollars of extra, after-tax investment income for a typical high income family. Ultimately, arriving at the right decision always depends on correct analysis of unique family financial circumstances, including the many factors that apply uniquely to Americans abroad. As always, it is best to consult with a qualified investment advisor or tax consultant before making a final decision.

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This note is the second in a series on retirement planning for American Abroad for Thun Financial Advisors

Appendix A: Attributes of Traditional IRAs and Roth IRAs

	Traditional IRA	**Roth IRA**
Tax advantage	Tax-deferred earnings.	Tax-free earnings.
Eligibility[1]	• Investors must have earned income equal to or greater than their contribution. • Investors must be under age 70½. • There is no limit on income, but contributions may not be tax-deductible	• Investors must have earned income equal to or greater than their contribution. • Investors modified adjusted gross income must fall within the limits prescribed by the IRS.
Maximum contribution allowed by law	• $5,000 for tax year 2009 ($6,000 if age 50 or older).	• $5,000 for tax year 2009 ($6,000 if age 50 or older). • The maximum Roth contribution depends on the investor's income.
Tax deductibility	• If the investor (and spouse, if married) were not covered for any part of the year by an employer plan, they can deduct their total contributions up to the lesser of $5,000 ($6,000 if age 50 or older) or 100% of compensation.	• Contributions are nondeductible.
Taxes on withdrawals	• Ordinary income tax on earnings and deductible contributions. • No federal tax on nondeductible contributions. • State tax may apply.	• Distributions from contributions are federally tax-free. • Distributions from earnings are federally tax free if over age 59½ and have owned the Roth IRA for at least five years. If under 59½, distributions are tax-free if the investor owned the Roth IRA for at least five years and the distribution is due to death or disability or for a first-time home purchase (with a $10,000 lifetime maximum for the latter). • State tax may apply.
Penalty for early withdrawal[2]	• 10% federal penalty tax on withdrawals before age 59½ unless an exception applies.	• Distributions from contributions are penalty-free. • 10% federal penalty tax on withdrawals of earnings before age 59½ unless an exception applies.
Required minimum distributions	• After age 70½. • Exception: A new federal law allows investors to skip their RMD for 2009.	• None.

[1] If married and filing a joint income tax return, the nonworking spouse may also contribute to an IRA. The total contribution for both spouses cannot exceed the income of the working spouse for the contribution year.

[2] Distributions received before reaching age 59½ may not be subject to the 10% federal penalty tax if the distribution is for a first-time home purchase (lifetime maximum of $10,000), post-secondary education expenses, substantially equal periodic payments taken under IRS guidelines, certain medical expenses exceeding 7.5% of adjusted gross income, an IRS levy on the IRA, health insurance premiums (after receiving at least 12 consecutive weeks of unemployment compensation), or disability or death.

Appendix B: Scheduled Changes to IRA Rules

	Current Rules	Rules as of January 2010
Contributing to a Roth IRA	Individuals with modified adjusted gross income (MAGI) below $120,000 or married couples with MAGI below $176,000 are eligible to contribute, assuming that they have earned income at least equal to their contribution.	No change to the current rules but traditional IRA contributions can be immediately converted.
Converting to a Roth IRA	An individual can convert a traditional IRA or employer plan to a Roth IRA if his or her MAGI is $100,000 or less. Married couples who file separately cannot convert (unless they have lived apart for more than one year).	The income limit disappears. Any taxable income created by the conversion can be either: - Divided evenly between the 2011 and 2012 tax years. - Or recognized in 2010. Married couples who file separately are allowed to convert

Appendix C: Changing Federal Tax Rates

Marginal income tax rates	**2002**	**2003–2007**	**2008–2010***	**2011***
Thresholds based on 2009 taxable income**				
Single: Over $372,950 Married filing jointly: Over $372,950	38.6%	35%	35%	39.6%
Single: $171,551–$372,950 Married filing jointly: $208,851–$372,950	35%	33%	33%	36%
Single: $82,251–$171,550 Married filing jointly: $137,051– $208,850	30%	28%	28%	31%
Single: $33,951–$82,250 Married filing jointly: $67,901–$137,050	27%	25%	25%	28%
Single: $8,351–$33,950 Married filing jointly: $16,701–$67,900	15%	15%	15%	15%
Single: $0–$8,350 Married filing jointly: $0–$16,700	10%	10%	10%	No 10% bracket
Capital Gains Tax Rates				
Long-term capital gains (10% and 15% tax brackets)	10%	5%	0%	10%
Long-term capital gains (All other tax brackets)	20%	15%	15%	20%
Short-term capital gains	Taxed as ordinary income	Taxed as ordinary income	Taxed as ordinary income	Taxed as ordinary income
Dividend Tax Rates				
10% and 15% tax brackets	Taxed as ordinary income	5%	0%	Taxed as ordinary income
All other tax brackets	Taxed as ordinary income	15%	15%	Taxed as ordinary income

* For 2010 and 2011, the table reflects what is outlined in the current tax code.
** These tax tables adjust annually for inflation.

	State	Top Marginal State Income Tax Rate
1	Hawaii	11.00%
2	Oregon	11.00%
3	California	10.55%
4	Rhode Island	9.90%
5	Iowa	8.98%
6	New Jersey	8.97%
7	New York	8.97%
8	Vermont	8.95%
9	Washington D.C	8.50%
10	Minnesota	7.85%
11	Idaho	7.80%
12	North Carolina	7.75%
13	Wisconsin	7.75%
14	South Carolina	7.00%
15	Arkansas	7.00%
16	Delaware	6.95%
17	Montana	6.90%
18	Maine	6.85%
19	Nebraska	6.84%
20	Connecticut	6.50%
21	West Virginia	6.50%
22	Kansas	6.45%
23	Maryland	6.25%
24	Tennessee	6.00%
25	Georgia	6.00%
26	Kentucky	6.00%
27	Missouri	6.00%
28	Louisiana	6.00%
29	Ohio	5.93%
30	Virginia	5.75%
31	Oklahoma	5.50%
32	Massachusetts	5.30%
33	Alabama	5.00%
34	Utah	5.00%
35	Mississippi	5.00%
36	New Hampshire	5.00%
37	New Mexico	4.90%
38	North Dakota	4.86%
39	Colorado	4.63%
40	Arizona	4.54%
41	Michigan	4.35%
42	Indiana	3.40%
43	Pennsylvania	3.07%
44	Illinois	3.00%
45	Alaska	0.00%
46	Nevada	0.00%
47	Texas	0.00%
48	Wyoming	0.00%
49	Florida	0.00%
50	South Dakota	0.00%
51	Washington	0.00%

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