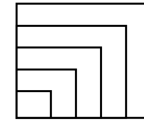
Drain the Traditional IRA Early?



The common assumption and advice is that it is better to leave money in qualified accounts such as a Traditional IRA as long as possible in order to "benefit from tax-free growth." The assumption is that having the opportunity to invest the money that would have gone to taxes results in higher gains. Obviously that is not true if the investment suffers losses, but even with gains, often that is not the case.

Converting a Traditional IRA to a Roth IRA and paying the attendant income taxes upfront can have identical investment results years later. To have the results match to the penny years later is counter intuitive for most people, so you may want to study the example in the table below and even create your own table and calculations.

	Pre tax (IRA)		**Post tax (Roth IRA)**			
Annual Return	Tax Rate	Balance	Tax Rate	Annual	Annual	Balance
10%				Gain	Tax	
Initial		100,000				100,000
Year 0			15%		15,000	85,000
1	0	110,000	0	8,500	0	93,500
2	0	121,000	0	9,350	0	102,850
3	0	133,100	0	10,285	0	113,135
4	0	146,410	0	11,314	0	124,449
5	0	161,051	0	12,445	0	136,893
6	0	177,156	0	13,689	0	150,583
7	0	194,872	0	15,058	0	165,641
8	0	214,359	0	16,564	0	182,205
9	0	235,795	0	18,221	0	200,426
10	0	259,374	0	20,043	0	220,468
Tax Year 10	15%	38,906			0	0
After Withdraw al		220,468				220,468

To explain the numbers in the table, we start with a hypothetical $100,000 and 10% annual returns in both cases. In the pretax columns reflecting the Traditional IRA, the $100,000 earns 10% each year for ten years at which time it is withdrawn and taxed at 15% ordinary income tax rates, leaving $220,468. In the post-tax or Roth IRA columns, the $100,000 is converted to a Roth IRA at the beginning and taxed at 15%. It then has annual returns of 10%, all without income taxes, and an identical valuation ten years later of $220,468.

While the principles are the same, in practice rather than taking the distribution all at once one would usually take earlier distributions each year in amounts that don't precipitate an unwanted tax rate. Of course the same mathematics and implications apply for any qualified plan, such as a 401(k), 403(b) or SEP.

Variations in results occur only if the tax rate now is different than the tax rate incurred years later. Tax rates incurred may be lower later, but they may not. The tax schedule and rates may change. Or as is often the case, someone retires at say age sixty and the taxable income is lower until age sixty seven when Social Security begins. The taxable income goes up again at age 70½ when the IRA Required Minimum Distributions (RMD) begin. For some, a pension kicks in. There may be a part-time job to provide stimulation to life. On top of this, assets grow as we get older and related income is added to the tax bite. Many people have higher taxable income in retirement than they did when employed. If ones tax rate is going to be the same or become higher, it is better to start draining the IRA by converting to a Roth.

If someone is in a 15% tax bracket and paying no capital gains taxes, the same dynamics apply for taking an IRA distribution and investing for capital gains rather than converting to a Roth IRA.

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Flexibility is a major reason to drain the Traditional IRA, even when the tax rates and thus returns are identical. What if money is needed for major expenses such as for medical expenses, a home remodel, a trip, a grandchild's education or an investment not readily available within an IRA? Having to take a large distribution for these items on top of already high taxable income can boost the tax rate. The flexibility advantages may even make it worthwhile to incur some capital gains taxes.

If heirs should be so unfortunate as to suffer your demise, the Traditional IRA is added to their taxable income, even if astute planning has it spread over time. Will the resulting taxes be higher than if you paid them now? Would the administration be simpler?

To be fair, one disadvantage of taking the distributions now and converting or placing the funds in an after-tax account is that the numbers are smaller and the net worth looks like less. Many net worth statements include Traditional IRA valuation numbers alongside valuations for Roth and taxable accounts. Obviously this is a distortion, as the Roth and taxable accounts reflect spendable money, while the Traditional IRA accounts are subject to income taxes before having spendable money. An accurate net worth statement would include a figure for the eventual tax subtracted from the value of the Traditional IRA.

The bottom line is that in both financial planning and investing, we suffer from a lot of false assumptions and heuristics. Work the numbers.