Roth Conversions

A Roth conversion is the transfer of funds from a Traditional (pre-tax) retirement account to a Roth (after-tax) retirement account. Taxes are paid on the funds converted in the year of conversion.

Deductible contributions to traditional IRAs are made with earnings that have not yet been taxed. Roth IRA contributions, on the other hand, are made with after-tax dollars. When a Roth conversion is completed, the tax that was deferred in the traditional IRA must now be paid.

A Roth conversion allows the taxpayer to decide when to pay the tax. The best strategy is to convert during years when the taxpayer is in a relatively low tax bracket. This allows the taxpayer to pay the tax at a lower tax rate and increase the after-tax value of their portfolio.

A typical strategy is to handle conversions after retirement but before required minimum distributions (RMDs) and/or Social Security begins. Taxpayers often face lower tax rates during this period.

Benefits of Conversion

Increase the after-tax value of your investment portfolio

The main difference between traditional and Roth IRAs is when taxes are paid. Roth conversions allow a taxpayer to choose to pay the tax during years when they are in a relatively low tax bracket.

Reduction of future RMD[1]'s and, possibly, future tax bracket

Roth conversions reduce the balance in the traditional IRA account. This, in turn, reduces future RMDs. Consequently, this is a way to manage future tax brackets.

Extend tax-free growth of retirement accounts

Owners of traditional IRAs must take RMDs starting at age 73. Owners of Roth IRAs are not subject to RMDs. Roth conversions increase the portion of assets that can continue to receive tax deferral over time.

Estate tax management

Roth conversions reduce estate value since tax must be paid on the conversion. However, the real net worth (after-tax value) to the owner does not change.

Manage tax impact on heirs

Non-spousal heirs of IRAs are required to withdraw the funds by the end of the tenth year after the date of death. In the case of large IRAs, this could create a significant tax impact for the heir(s). While Roth IRAs must also be withdrawn in the ten-year period, the withdrawal is tax-free. Not only does this remove any impact on their taxes, but it also allows the heir(s) to keep the funds in the tax-free account until the very end and maximize their tax-free growth.

[1]Required minimum distributions

Who Should Consider A Roth Conversion

✓ Taxpayers who expect to be in a higher tax bracket in the future

A Roth conversion allows the taxpayer to choose to pay the tax while in a low tax bracket.

✓ Someone who will not spend their full required minimum distributions (RMDs)

Ongoing tax deferral provides greater benefit if assets are not being used for living expenses or other needs.

✓ Households that are likely to face an estate tax

Converting assets from an IRA to a Roth IRA reduces the estate value but not after-tax net worth.

✓ Taxpayers whose children/heirs are in a higher tax bracket

Heirs will receive a greater after-tax benefit if taxes are paid at a lower current rate than their future higher rate.

✓ Individuals who are not leaving significant assets to charitable organizations

For taxpayers with charitable inclination, leaving traditional IRAs to charities can be an optimal strategy. The charity does not pay taxes on the IRA and the donation is excluded from estate tax calculations. In this case, Roth conversions do not make sense.

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Other Considerations

Roth conversions increase taxable income in the years they are completed. Work with your financial advisor and accountant to monitor the following:

- Current tax bracket may increase depending upon the amount converted
- A Roth conversion may cause your Medicare premium to rise
- Compare your current and expected future tax rates in order to calculate optimal conversions

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