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CAPITAL MANAGEMENT

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Is a Roth IRA Conversion Right For Me?

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Recently, you may have been hearing a lot about Roth IRA conversions; I certainly have been receiving a lot of questions about them from our clients. First, let's define a few key terms and then lead into whether a Roth conversion could be appropriate for you.

TRADITIONAL IRAs AND ROTH IRAs

Traditional IRAs are typically established with pre-tax dollars to defer income (and taxation) during your working years so they can be invested to grow and compound as a nest egg during the years leading up to retirement. Assets are normally taxed upon withdrawal from a Traditional IRA.

Like Traditional IRAs, Roth IRAs are also established to fund retirement expenses. Unlike Traditional IRAs, however, Roth IRAs can be initially funded with after-tax dollars (subject to income limitations, as discussed below) that grow tax-free, including upon withdrawal. Alternatively, a previously established Traditional IRA can be subsequently converted to a Roth IRA, however doing so could have significant tax implications and should involve a discussion with your CPA.

CONSIDERATIONS

The year in which a Traditional IRA is converted to a Roth IRA involves accelerating the recognition of ordinary income in the form of all or a portion of the tax-deferred dollars in your Traditional IRA. This will be treated as income to you and any tax will generally be due in the year in which it is recognized. Accordingly, it is sometimes prudent to spread a Roth IRA conversion across multiple tax years.

There are many reasons to consider a Roth IRA conversion but here are three of the most common:

1. You are experiencing a relatively low income year which is temporary (such as from loss of employment) or more permanent (such as semi-retirement or retirement) and would like to recognize income currently because you are in a relatively low tax bracket.

2. You prefer to avoid RMDs (Required Minimum Distributions) which are one of the Roth IRA's main attributes compared to the Traditional IRA.[1] Without RMDs, Roth IRAs can continue to compound and grow over the years without losing assets due to RMDs that would otherwise begin.

3. You have one or more large tax deductions that can be used as offsets to reduce your taxable income during the year(s) of the Roth IRA conversion.

FINAL THOUGHTS

Typically, the closer you are to taking RMDs (currently April 1 of the year following the calendar year in which you reach age 72), the less appealing Roth IRA conversions may be. Given the various factors involved, it's best to have your CPA run projections for you to get a better sense of whether or not you should proceed. Keep in mind that converting 100% of a Traditional IRA account to a Roth IRA is just one option. You can convert just a small portion of your account(s) to spread the effect of the income recognition over multiple years. Similarly, you can work with your CPA to 'tax bracket manage' and amplify your tax planning efforts.

Remember, converting to a Roth IRA with existing Traditional IRA assets is different than starting with fresh dollars in a new Roth IRA account. Contributions to Roth IRAs carry income limits, so setting up new Roth IRA accounts with cash is typically reserved for those investors who are earning less than $196,000 for joint filers and less than $124,000 for single filers (2020 limits; subject to phase-outs).[2]

NEXT STEPS

If you would like to discuss how any of these strategies affect your personal financial situation, please reach out to us anytime.

All the best to you and yours as we conquer the new year!

CONTACT US

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Sources:

[1] https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-required-minimum-distributions-rmds
[2] https://www.irs.gov/retirement-plans/plan-participant-employee/amount-of-roth-ira-contributions-that-you-can-make-for-2020

Important Information: