ROTH CONVERSIONS –
COULD THEY BE GOOD FOR YOU??

by, April Schultz October 2022

What is a Roth conversion?

A Roth conversion involves converting a portion of funds from a pre-tax retirement account, (e.g., a traditional IRA or 401(k) plan) into a tax-free Roth account. Of course, there's "no free lunch", and you'll need to pay tax now on the amount of the conversion (instead of in the future when the funds are distributed). The amount converted is treated as a taxable distribution and is taxed as ordinary income. All of growth after the conversion and any future distributions from the Roth account are tax free. (As long as they meet basic requirements to be considered "qualified distributions")

How do I know if a Roth conversion could benefit me?

Simply put, a Roth conversion is beneficial when a person's current tax bracket is lower than it is expected to be in the future. This is because the tax paid on the converted funds in the current year is at a lower rate, effectively spreading out the tax liability to utilize lower brackets. This can have a huge impact in tax savings by taking advantage of years with lower taxable income, before taxable income increases, pushing you into a higher bracket. For example, most retirees find they have a "sweet spot", or optimal period of time to complete Roth conversions. This is typically after they retire, and before they start Social Security and reach RMD age (currently 72). Because they are in a lower tax bracket during this time, this is an optimal time to "fill up" their low tax bracket with taxable income from a Roth conversion, and allow this money to grow tax free. Furthermore, funds in a Roth IRA are also not subject to RMDs, reducing the size (and tax impact) of your required minimum distributions when it comes time to begin taking them.

Why is this strategy more effective in a bear market?

In a bear market environment (like we are currently experiencing), there's a chance to convert an asset that is significantly down in value from your IRA, thereby capturing the gains of the rebound in your tax-free Roth. You will pay tax on the amount of the conversion, but the tax is ultimately lower because the asset is down in price. Another way to think about it - if the overall value of the account is down, this allows for larger portion of the account to be converted to after tax dollars. If you were thinking of converting a certain amount of money, you will be able to convert a larger percentage of the account, while paying the same amount in taxes. This allows for a larger percentage of the account to enjoy the market rebound, tax free.

What are the rules around Roth conversions?

Unlike Roth *contributions*, there are no income restrictions for completing Roth conversions, and no limit on the amount you can convert during the year. There is also no limit on the number of conversions that can be done throughout the year from a Traditional IRA to a Roth IRA.

How much should I convert?

You first want to consider what your taxable income may look like in the future, and what tax bracket that would put you in. You want to be careful not to convert too much to ensure optimal tax savings. The key is to fill up the lower brackets today, but only until it reaches the point that your tax rate is as high as it is anticipated to be in the future.

When in the year should I convert?

It is advisable to convert later in the year when you have a strong understanding of your tax situation and know how much to convert to "fill up" the desired tax bracket. However, if you wait until the end of the year, you may miss an opportunity to convert when the market is down. Therefore, it may be beneficial to convert a portion of the total amount in the near term to take advantage of market conditions and convert the rest at the end of the year. That way, you can adjust the amount to be converted later in the year if your taxable income changes.

How should I pay for the taxes upon converting?

The most advantageous way to pay for Roth conversions is to pay the tax from cash in a savings account, instead of selling investments.

What are the advantages/disadvantages? Potential drawbacks to consider?

Do not convert just because the market is down if the other factors don't align. If you are currently in a high tax bracket and suspect your taxable income will go down in the future, then you are better off contributing to a traditional IRA and getting the current year tax deduction.

Roth Conversions can be a powerful tool to save on taxes and maximize the potential growth of your retirement nest egg. However, there are various factors to consider, and every situation is different. Be sure to discuss with your advisor to learn more.

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