Roth IRA Conversion

Factors to Consider

For many individuals, the ability to convert a traditional IRA to a Roth IRA represents a significant tax planning opportunity. However, before making such a conversion, there are a number of issues that must be clearly understood and considered.[1]

Pay Me Later or Pay Me Now

With a traditional IRA, and assuming certain requirements are met, contributions are deductible in the year they are made. The tax due on the contributions, and the tax due on any earnings or growth, is deferred until funds are distributed from the account, typically at retirement. From an income tax perspective, this is a "pay me **later**" scenario.

With a Roth IRA, contributions are never deductible; they are made with funds that have already been taxed. If certain requirements are met, both the contributions and any earnings or growth are received income-tax free when withdrawn from the account. From an income tax perspective, this is a "pay me **now**" scenario.

A taxpayer who elects to convert a traditional IRA[2] to a Roth IRA has chosen to pay the income tax now rather than waiting until the future to pay it. To justify a conversion, the benefit of not paying taxes tomorrow should be greater than the cost of paying taxes today.

Benefits of Roth IRAs

The benefits of holding assets in a Roth IRA can be considerable:

- **During life – tax-free income:** Assuming that certain requirements are met, including a five-taxable year waiting period after a contribution is first made to a Roth IRA for the owner, "qualified" distributions are received income-tax free.

[1] This discussion here concerns federal income tax law. State or local income tax law may differ.

[2] Although the discussion here focuses on traditional IRAs, the same rules apply to amounts converted from a SEP IRA or SIMPLE IRA to a Roth IRA. Funds in a SIMPLE IRA that do not meet the two-year period described in IRC Sec. 72(t)(6) may not be converted. Distributions from IRC Sec. 401(a) qualified retirement plans, IRC Sec. 457(b) governmental plans, and IRC Sec. 403(b) plans may also be rolled over into a Roth IRA.

- **At death – income-tax free to beneficiaries:** At death, the value of the Roth IRA is includable in the account owner's estate, subject to federal estate tax. A surviving spouse can treat an inherited Roth IRA as his or her own, with the proceeds being received income-tax free, and with no required minimum distributions. For non-spousal beneficiaries, and assuming that the five-year waiting period requirement has been met, the proceeds are received income-tax free. After the owner's death, however, non-spousal beneficiaries must take certain required minimum distributions.
- **No lifetime required minimum distributions:** Federal income tax law mandates that certain required minimum distributions (RMDs) be made from traditional IRAs, beginning when the account owner reaches his or her required beginning date (RBD), currently age 73.[1] For Roth IRA owners, there are no minimum distribution requirements *during the lifetime* of the account owner.

The Cost of Conversion

Converting a traditional IRA to a Roth IRA is a currently **taxable** event. For the year the converted assets are distributed, the taxpayer must include in gross income all previously deducted contributions, plus net earnings (or minus net losses). For individual retirement annuities, gross income is generally increased by the fair market value of the contract on the date of conversion (through a re-designation) or distribution (if held inside an IRA). If a retirement annuity is completely surrendered, the cash received is the amount includable in income. Any 10% penalty tax for early withdrawal is waived.

If a taxpayer has traditional IRA accounts that hold both deductible and non-deductible amounts, he or she may not "cherry-pick" and convert only the non-deductible contributions.[2] Instead, the value of all IRA accounts is added together and a ratio is calculated to determine the tax-free portion of any conversion.[3]

[1] Under current regulations, the age to begin RMDs increases after 2022 to: (1) age 73 for those born from 1951 to 1959; and (2) to age 75 for those born after 1959. Previously, age 72 was the mandated age to begin RMDs.

[2] Because they have already been taxed, non-deductible contributions are generally not taxable when converted from a traditional IRA to a Roth IRA.

[3] If all of the contributions to the traditional IRA were deductible, a taxpayer may elect to roll over everything, or pick and choose which accounts or portions of an account to convert.

Example: Paul has a traditional IRA to which he has made $20,000 in non-deductible contributions. This year, when he converts the account to a Roth IRA, the balance in this IRA is $30,000. Paul also has a separate IRA containing $70,000 in pre-tax contributions rolled over from a 401(k) plan with a previous employer. The total value of both accounts is $100,000. His “non-deductible” ratio is thus 20%, ($20,000 ÷ $100,000). When Paul converts the $30,000 in his non-deductible IRA, he may exclude only $6,000 (20% x $30,000) from gross income. The remaining $24,000 ($30,000 - $6,000) is includable in his gross income, subject to tax.

Situations Favoring Conversion to A Roth IRA

- **Small account values:** If the dollar amount in the traditional IRA is small, the income-tax cost to convert today would be relatively low.
- **Longer time to retirement:** A longer period of time until retirement allows for greater future growth, necessary to recoup the up-front cost of paying the tax now.
- **Cash to pay the taxes:** Where will the money come from to pay the extra taxes? It’s usually better if the account owner has sufficient cash outside of the IRA to pay the tax. Could the funds used to pay the tax today provide a greater return if invested elsewhere?
- **IRA income not needed:** Some individuals have adequate retirement income from other sources, so that IRA monies are not needed to fund retirement. During the lifetime of the account owner, a Roth IRA has no minimum distribution requirements.
- **Higher future tax bracket:** If a taxpayer anticipates being in a higher tax bracket in the future, paying the tax today, at lower rates, is a logical step. Being taxed at a higher marginal rate may be the result of legislative changes, having a higher taxable income, or a change in filing status, such as when a couple divorces or a spouse dies.

Situations NOT Favoring Conversion

In some situations, converting a traditional IRA to a Roth IRA may not be appropriate:

- **Retirement begins soon:** If there is only a short time before retirement begins, there may not be enough time for future growth to offset the cost of paying the tax today.
- **High IRA account values:** If the dollar amount in the traditional IRA is large, the tax bill resulting from the conversion will likely be expensive; the conversion could push a taxpayer into a higher marginal tax bracket or make Social Security benefits taxable.
- **No cash to pay the taxes:** A taxpayer may not have the cash outside the IRA to pay the extra tax that results from the conversion. Taking funds from the IRA to pay the increased tax reduces the amount left in the account to grow into the future. If the account owner is under age 59½ at the time these extra funds are withdrawn from the IRA, a 10% penalty on the amount not converted will likely be added to the tax bill.
- **Lower future tax rates:** If a taxpayer anticipates being in a lower tax bracket in the future, paying the tax today, at higher marginal tax rates, makes no sense.

Recharacterization

Prior to 2018, a taxpayer who converted a traditional IRA to a Roth IRA could "undo" the transaction and "recharacterize" the funds, moving them back into a traditional IRA.

Beginning in 2018, however the Tax Cuts and Jobs Act of 2017 (TCJA), permanently repealed the ability to recharacterize a Roth conversion back to a traditional IRA.

Seek Professional Guidance

The decision to convert all or part of a traditional IRA to a Roth IRA is an individual one. A thorough analysis requires careful consideration of a number of income tax, investment, and estate planning factors, over an extended time horizon. The advice and guidance of appropriate financial, tax, and investment professionals is strongly recommended.

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