Roth IRA Conversions

Roth IRAs provide significant advantages to an individual in retirement, among them being tax-free withdrawals. Roth Conversions are a way to save in this bucket, but careful planning must be done before pursuing this strategy.

Baird Private Wealth Management

THE ADVANTAGES OF A ROTH IRA

The Roth IRA can be an invaluable resource in retirement. The greatest benefit is that withdrawals are tax-free. This means you can take money out without driving up your tax bill, or perhaps often-overlooked – your Medicare premiums under the Income Related Monthly Adjustment Amount (IRMAA) rules. This provides you with extra flexibility, particularly in years with higher expenses. Another benefit of the Roth IRA is that there are no required minimum distributions during the individual's lifetime. This allows for maximum tax free growth of assets.

From a legacy standpoint, the Roth IRA might be a desirable asset to leave for heirs. As a result of the SECURE Act, passed at the end of 2019, beneficiaries of IRAs are no longer able to stretch their distributions over their lifetime. Instead, they must deplete the balance over a 10 year period starting the year after the original owner's death, which can result in a larger tax bill when getting a Traditional IRA. For this reason, those wishing to leave a legacy to heirs may consider paying a portion of the taxes today via a Roth conversion. While an inherited Roth IRA also has a 10 year distribution period, the withdrawals remain tax free.

CONVERSION CONSIDERATIONS

- If your tax rate today is less than what you expect it to be in the future, you can convert your Traditional IRA to a Roth IRA and pay taxes now, rather than taking IRA distributions during retirement when you are in a higher tax bracket. Even if your tax rate today is *equal* to your future rate, there may be some value in doing a conversion, as it allows for greater flexibility.
- You should be careful to avoid converting too much in a single year. If the conversion amount ultimately pushes you into a higher bracket than you would be in retirement, it may not be worth it. Instead, consider converting a smaller amount to fill up your current marginal tax bracket. Also pay attention to other tax related thresholds, such as Net Investment Income tax and other AGI-related phaseouts, like the medical expense deduction.
- For the best outcome, you should have money outside of the IRA to pay the taxes. Money in the IRA is best left to grow and taking a distribution to pay for taxes on a conversion may be subject to further penalties.
- In general, an individual cannot contribute to a Roth IRA directly if your income is greater than $196,000 for a married couple (or $124,000 for a single individual) in 2020. However, with Roth Conversions, there is no income limit, so it provides an attractive option for those who still want to save in this tax bucket.
- By converting to a Roth IRA, you can avoid the required minimum distribution (RMD) rules mandate at age 72, thereby allowing your account to grow tax-free for a longer period of time. While a projection of RMDs might be relatively low, you should consider your other retirement income sources and your need for income.

- When contributions are made to a Roth IRA, an individual can always take out principal tax-free, regardless of age. For Roth conversions, this works slightly differently. Each conversion has a separate 5-year clock for determining whether or not a distribution of the converted amount from the Roth IRA will be subject to an early withdrawal penalty. A distribution of any converted amount within 5 years of the conversion may result in a 10 percent early withdrawal penalty, if another exception does not apply. These exceptions include:
  - Attainment of age 59-½; or
  - Death; or
  - Disability; or
  - "First-time" home purchase (lifetime limit of up to $10,000)

  In addition, if the individual has not had a Roth IRA open for 5 years, their earnings on the converted amount, or growth on a regular contribution would be taxable.
- IRA conversions use the pro rata rule if your IRA contains both pre-tax and after-tax contributions. The amount of the conversion which will be tax free can be determined by using the following formula:

	Non-deductible contributions
÷	Total IRA balances*
x	Conversion amount
=	Tax-free conversion amount

*Total IRA balance includes all Traditional (contributory and rollover), SEP, and SIMPLE IRAs. Inherited IRAs and qualified employer plans (401(k), 403(b), etc.) are not included. It is important to note that the balances are determined at year-end, not at the time of conversion, so if a rollover of 401(k) funds is expected before year end, a larger portion of the conversion may be taxable.

Example - An individual has a total of $200,000 held in three separate IRA accounts – $180,000 is pre-tax (rollover and after-tax earnings), and the remaining $20,000 represents after-tax contributions. If the individual wants to convert $30,000, how much of the conversion will be taxable?

Using the formula, we can determine the amount of the $30,000 conversion that will be tax free. The remaining amount will be taxable.

	$20,000
÷	$200,000
x	$30,000
=	$3,000

Of the $30,000 conversion, $3,000 will be tax free. The remaining $27,000 will be reported as income and taxed accordingly.

To discuss Roth IRA conversions further, please contact your Baird Financial Advisor.