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Considerations of Roth conversions

Explore the potential benefits and drawbacks of taking Roth conversions.

Roth conversions involve paying taxes now to create tax diversification later. This may appeal in times of market volatility, if you feel tax rates will increase in the future or if you want to "prepay" taxes for your beneficiary.

AN OVERVIEW OF ROTH CONVERSIONS

A Roth conversion moves all or part of your traditional pre-tax IRA to a Roth IRA. Roth conversions are used as a tax planning strategy: accelerating income taxes due on the converted amount to create tax-free retirement account growth.* Generally, amounts converted will be subject to ordinary income tax in the year converted. If your traditional IRA has after-tax contributions, any distributions, including distributions as a result of a Roth conversion, will be subject to the pro-rata rule.

WHY CONSIDER A ROTH CONVERSION?

- Individuals may convert because they believe their tax bracket will be lower today than in the future.
- Taxable income or tax rates in current year are lower than is expected in future years.
- Pay taxes now so that beneficiaries can inherit from the Roth IRA tax free* if certain qualifications are met.
- The SECURE Act limited "stretch" provisions. Many beneficiaries will have to take distributions of traditional IRAs over 10 years, creating more of a tax burden than the previous stretch rule. A Roth IRA must still be distributed within 10 years. However, since the distributions from a Roth account are tax free, your beneficiaries can take the distributions with no tax consequences.
- Conversion is a planning opportunity to create tax-free income* for beneficiaries. It may also be used if the beneficiary is, or plans to be, in a higher tax bracket than the IRA owner or themselves when the account is received.
- Create tax diversification in retirement. Roth IRA distributions are generally tax-free,* whereas traditional IRA distributions are taxable.
- Having some of each (taxable and tax-free) accounts allows retirees to adjust to the future tax environment.
- Limit future required minimum distributions – RMDs – for tax bracket management. A Roth conversion will result in a smaller traditional IRA, which equates to lower RMDs.
- Roth IRA distributions do not increase counted income for Social Security or Medicare.

- RMDs are not eligible for a Roth conversion. If you are subject to an RMD, it must be withdrawn and may not be converted to Roth. However, you are permitted to convert an additional amount beyond the RMD to Roth.
- Implementing a Roth conversion while the asset values are depressed could result in a lower tax bill for the securities rolled over, and any resulting appreciation due to a market rebound will grow in the tax-free* Roth IRA. Roth conversions may be done "in-kind," allowing you to fully participate in any market recovery.

POTENTIAL CONSIDERATIONS OF A ROTH CONVERSION

Implementing a Roth conversion means paying more taxes now, which may not be beneficial if you are in a higher tax bracket today than you expect you will be in the future, or if you expect tax rates to decline. Also, Roth conversions increase your AGI in the year of conversion. This may affect other tax deductions, credits and related items, such as Medicare premiums.

A Roth conversion also isn't beneficial if you need the distributions for immediate expenses. Many individuals may still rely on traditional IRA distributions for a component of their income. IRAs used for current income may not see the benefit of tax-free appreciation of the Roth IRA.

When implementing a Roth conversion, consider paying taxes from an outside source, allowing all of the converted funds to grow as opposed to taking a withdrawal from the plan to pay taxes. Keep in mind, distributions from an IRA when the participant is under 59 1/2 may be subject to a 10% penalty.

Also, consider your beneficiaries. If you intend to leave your traditional IRA to a charity, it may not make sense to pay additional taxes today for money that the charity wouldn't be taxed on upon receipt.

Please speak with your advisor about whether a Roth conversion may be beneficial for you.

*In order for earnings to be tax-free, converted funds must be held in the Roth IRA for five years and distributions must occur after age 59 1/2 or as a result of death, disability or first-time home purchase of $10,000. A separate five-year period applies for each conversion.

WHAT ARE RMDs?

You cannot keep funds in a traditional IRA indefinitely. Individuals are required to withdraw amounts known as required minimum distributions after age 70 1/2 or 72 for those born after June 30, 1949.

WHAT ARE THE STRETCH PROVISIONS?

The 2019 SECURE Act limited the amount of time many non-spousal beneficiaries can "stretch" withdrawals from inherited IRAs. Previously, many beneficiaries could stretch distributions over their expected lifespan whereas under the SECURE Act, many beneficiaries must liquidate the account within 10 years. Those that are able to stretch distributions over their lifetime are limited. Please speak with your financial advisor for more information.

Source: Fidelity Investments

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