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Converting an IRA to a Roth IRA

There is a strategy known as the IRA to Roth IRA conversion that may work for you to reduce income tax bills later in the future.

It's not for everybody, but here is a brief summary. It allows account owners to transfer some or all of the money in a tax-deferred IRA to a Roth IRA. There is paperwork involved.

You may also be able to convert your 401(k), 457, and other retirement plans to a Roth IRA. Some employers offer the option of using a Roth IRA instead of their other retirement plans.

In a Roth IRA conversion, you contribute after-tax dollars, get tax-free build up, tax-free withdrawals after five years, no RMDs, and estate planning potential benefits.

Why maybe do the conversion now?

Let's look at a hypothetical example to illustrate the concept. You have no current or planned need for income or distributions from your IRA. Think of the IRA when converted to Roth IRA as untouchable for 5 years.

You decide to convert $100,000 ($100K) of a $300K IRA. Be sure to check with your tax advisor if this strategy is appropriate for you because I do not give tax advice.

If you do the conversion this year, you pay taxes on taking the money out of the IRA, called a distribution. On $100K at maybe 25%, that is about $25K of liability to the IRS this year . You may also have other income that you should figure in.

If you use the conversion money to pay the taxes, that will leave you with $75K for your new Roth IRA. You could also use outside money to pay the tax bill, so the full $100K is now in your Roth IRA.

When you make the conversion, the conversion clock starts running. After five years, your Roth IRA has increased to $130K. You can withdraw whatever amount from your Roth IRA tax free, if you are over 59 1/2. That's quite a deal. Under 59 ½ and there may be taxes.

There are many investment choices within your Roth IRA, such as stocks, mutual funds, ETFs, etc.

Here are some other things to consider. If you think tax rates will be rising in the future, then consider a Roth IRA conversion this year.

If you are under 59 ½ and do a Roth conversion, there are taxes. There is no additional 10% IRS tax if you elect to pay the conversion taxes from non-IRA assets.

Doing the conversion with both alive may save taxes. If a spouse dies, generally the survivor next year may be pushed into a higher tax bracket.

If you are over 50 with earned income, you may be able to contribute to your Roth IRA depending on your total income.

With a Roth IRA conversion, you would create an opportunity where your money could grow and compound tax fee until you die.

The beneficiary who inherits your Roth IRA will have to take annual RMDs, but they won't have to pay any federal income tax on their withdrawals as long as the account's been open for at least 5 years. Any distribution is tax free.

The complicated SECURE ACT rules then apply to the beneficiary.

Do a second Roth IRA conversion, and a new 5-year clock starts running on the second conversion.

There are many details not covered in this brief summary and the laws may change. Has your tax advisor or financial planner mentioned this strategy?

You could be a candidate for a Roth Conversion and now may be a good time to consider it.

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