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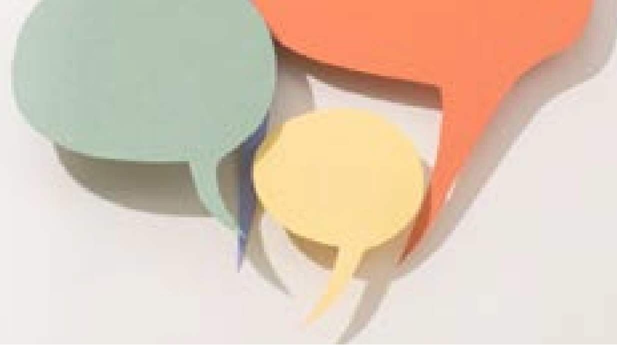


Roth IRA Conversions—Why Does Everyone Talk About Them?

Roth conversions are a widely discussed planning topic among advisors with their clients. They've become a "hot word" in planning discussions, are often referenced in financial articles, and tend to always be discussed in Congress when new tax laws are being proposed. There are many benefits of Roth conversions that can be very attractive depending on a client's financial circumstances as well as a client's goals and objectives with their wealth. In this paper we will explore what Roth conversions are, the benefits of making a conversion, and the tax implications of executing conversions.

Thinking about making a Roth IRA conversion? We discuss the important considerations to make in deciding if a conversion is for you.

What are Roth Conversions?

A Roth conversion at a very high level is just a transfer from a Traditional IRA to a Roth IRA.

The difference between the two accounts is a Traditional IRA is funded with pre-tax dollars and a Roth IRA is funded with post-tax dollars meaning:

- In the **Traditional IRA,** you most likely did not pay tax on any contributions to that account so when you take distributions, those dollars are subject to ordinary income taxes on the full amount of the distribution[1] and...
- In the **Roth IRA**, the account is funded with post-tax dollars meaning any amounts contributed or converted into the Roth IRA have already had taxes paid on them and any distributions are NOT subject to any taxes[2].

It's called a conversion because you are converting a pre-tax asset in the Traditional IRA to a post-tax asset in the Roth IRA.

I've heard there are limitations on contributing to a Roth IRA.

This is true, there are income limitations on who can make *contributions* to a Roth IRA, but there are **NO** limitations on who can make *conversions* to Roth IRAs.

A contribution is when you receive income and contribute a portion of that income to the specified account. For example, a deferral from your salary to a Roth retirement account is considered a contribution.

If a Traditional IRA already has a balance and transfers all or a portion of the balance to a Roth IRA, this is considered a conversion.

What are the benefits of Roth Conversions?

1 **The first major benefit is that zero tax is paid on the future appreciation of the assets held in the Roth IRA. Any amounts held in a Roth are distributed tax free[2] to the individual where any amounts distributed from a traditional IRA increase the individual's taxable income dollar for dollar[1].**

Let's assume you have a Roth IRA with a balance of one million dollars. If it grows to two million dollars in 10 years and you take a full distribution of two million dollars. None of the distribution would be subject to tax[2]. This is because the original one million dollars was already taxed and any growth of the assets in the Roth IRA are not subject to additional tax.

Conversely, using the same example. If instead the account was a Traditional IRA and you made the same distribution, you would pay ordinary income tax on all two million dollars[1].

2 **The second major benefit is paying less tax on the converted amount if you anticipate your tax bracket will be higher in later years.**

In this case, let's assume your current marginal Federal and State income tax bracket is 33.3% (24% Federal and 9.3% State[3]) and you anticipate your tax rate increasing in later years for any reason (increased pension distributions, required minimum distributions from pre-tax retirement accounts, installment sale of a business, etc.).

Making conversions now will tax the converted amounts at your lower tax rate today and let those amounts grow tax free for the future.

In the opposite scenario, if an individual were subject to the highest marginal tax brackets at 50.3% today (37% Federal and 13.3% State[3]) then we would not want to do conversions because every dollar converted would be subject to a 50.3% tax rate.

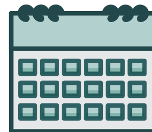
Individuals can select any dollar amount that they want to convert. By following this approach, individuals can increase the maximum value of the dollar amounts exposed to lower tax brackets to subject less of their pre-tax dollars to higher tax brackets. We should note that anyone considering Roth conversions should work with their CPA or tax advisor to determine what tax bracket they anticipate being in and any unforeseen implications.

When does it make sense to make conversions?

There are three factors that are generally the major considerations for timing of Roth conversions. The first two considerations are the most important, while the third consideration may make the conversion more effective.

Current year anticipated tax bracket

As discussed earlier, since the amount of the conversion is included in ordinary income, we ideally want to convert only as much that fills the lower tax brackets (to get the most benefit). Understanding the highest values of the lower tax brackets will help to decide how much of a conversion to make.



Timeframe for growth

The longer the timeframe before the assets need to be converted, the better the outcome of the conversion strategy. All the future appreciation in a Roth IRA grows tax free similar to the traditional IRA but no amounts from the Roth are taxed at distribution[2]. The longer timeframe we have for compounding growth to occur in the Roth IRA, the more future appreciation we have that will not be subject to ordinary income tax[2].

Current value of the assets being transferred

Assets with depressed values that we believe will regain their value are the most advantageous to transfer. Any type of market correction can generally be a good time to make Roth conversions if the two considerations above also make sense. Converting depressed asset values will allow you to convert more shares of the same security for the tax cost. When those securities regain their market value in the Roth IRA that growth is tax free in the account and at distribution[2].

If you have additional questions or you're curious to learn more about incorporating this strategy into your financial plan, please reach out to your wealth advisor to discuss.

1 *It is possible to make after-tax contributions to a traditional IRA and have a portion of the account that is pre-tax and post-tax dollars. In the event there are post-tax assets in your traditional IRA, then a portion of your distributions from the account will be non-taxable. Please speak to a CPA to confirm the amount of tax owed on any distributions.*

2 *In general, distributions from a Roth IRAs are tax free. There are certain circumstances that may cause penalties and taxes on distributions. Please speak with a CPA prior to taking distributions if you are unsure of the tax implications.*

3 *Assumes taxpayer is taxed as a California resident based on married filing jointly tax filing status for tax year 2022. Tax brackets per filing status can be found via the California Franchise Tax Board.*

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