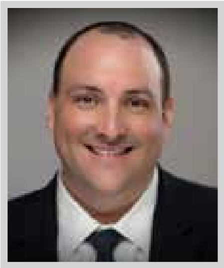
Roth IRA Conversion Considerations



By Brian Ellenbecker, CFP, EA, CPWA, CIMA, CLTC

A common question I often get from clients is whether a Roth conversion makes sense for them. I imagine many of you get the same question. Most of the time, the answer ends up being more complex than they thought, as there are a number of considerations that must be factored into the decision. There are tax and estate-planning considerations that sometimes span more than one generation and need to be evaluated.

This article will explore some of the most common things you'll want to consider when discussing Roth IRA conversions with your clients.

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Current tax rates vs. future tax rates

The key consideration when evaluating a Roth IRA conversion is how a client's current tax rate compares to their future tax rate when they would otherwise need to take a distribution from their pre-tax IRA. The main goal of a Roth IRA conversion is to shift money from a traditional IRA to a Roth IRA so those assets can grow tax-free going forward. However, any funds shifted are typically subject to income tax. The IRA owner is choosing to pay taxes sooner than they might otherwise have to, but if they are able to do so at a lower rate now, a Roth conversion is likely something to consider.

Many clients have a window between the time they retire and the time they need to start taking required distributions (RMDs) from their retirement accounts, when they will be in a relatively low tax bracket. They no longer have employment income from when they were working, and RMDs have not yet started. If they retired early, they may not yet be collecting Social Security or enrolled in Medicare, which are two items that can further complicate the calculation. This can be an ideal window to consider converting to a Roth IRA.

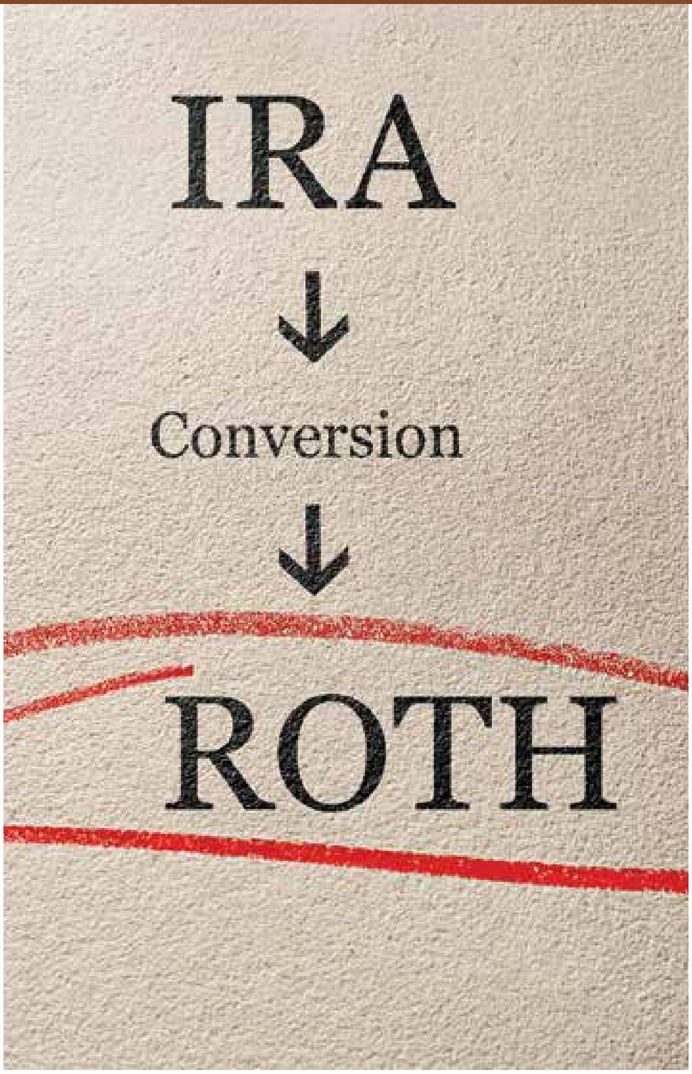
Planning note: If the client bought their health insurance plan from the Marketplace at Healthcare.gov, they may qualify for a premium tax credit. Any additional income from a Roth conversion could reduce the amount of the premium tax credit they are receiving.

Roth conversions vs. 0% long-term capital gains

If clients find themselves in the 12% ordinary income-tax bracket, some or all of their long-term capital gains and qualified dividends may qualify for the 0% tax rate. Access to the 0% bracket raises two planning points:

1. They may be better off realizing additional gains at 0% vs. doing a Roth IRA conversion. It's hard to beat generating income and paying no tax on that income. Gains can be realized by selling securities and immediately buying them back, essentially resetting the cost basis. There is no waiting period on realizing gains like there is with losses and the wash sale rule.[1]
2. Roth IRA conversions may push dividend or capital-gain income from 0% to 15%. If that's the case, the marginal tax rate on conversion income in this window will be higher than their current ordinary bracket and may even exceed what was expected to be a higher tax bracket in the future.

[1] https://www.kiplinger.com/taxes/604947/stocks-and-wash-sale-rule



Special tax attributes

In some cases, a client may have special tax attributes that make a Roth IRA conversion particularly attractive. If your client has things like charitable deduction carry-forwards, a high after-tax contribution basis in their IRA, investment tax credits, net operating losses, etc., they may be able to make a Roth conversion with low to no tax cost.

Consider beneficiaries

If the client expects to leave some of their retirement dollars to their heirs, be sure to consider their tax situation before making a Roth IRA conversion. If the heirs are the ones who will ultimately be the ones to withdraw funds from the IRA and incur any tax liabilities, factor in their expected tax rate and compare that to your client's current tax rate. If their rate is expected to be higher, a Roth IRA conversion will cost the client more in tax but could reduce the family's tax liability over time. Conversely, if the beneficiary is in a lower tax bracket than the one at which your client could convert funds, a Roth conversion would not make sense.

If the IRA owner plans to leave any portion of their IRA to charity, that amount should be left in the pre-tax bucket and not converted. The inheriting charity will not pay tax on the proceeds, so the client should not incur the tax liability from a Roth conversion during their lifetime. They may even want to consider opening a separate IRA for the portion they want to leave to charity and designate that charity as the sole beneficiary.

Beware of IRMAA

The income-related monthly adjustment amount (IRMAA) refers to the increase in Medicare Part B and Part D premiums someone has to pay once their modified adjusted gross income (MAGI) exceeds a certain threshold. In 2024, once income exceeds $206,000 for married taxpayers filing jointly or $103,000 for single filers, Medicare premiums will increase. There are six IRMAA income tiers, with the premiums increasing as income rises above each tier. For IRMAA purposes, MAGI is defined as AGI plus tax-exempt interest.

IRMAA can be tricky because this calculation does not appear anywhere on the tax return. Tax advisors need to be aware of it, though, as it can potentially add thousands of dollars to the cost of doing a conversion. IRMAA typically hits before someone reaches the top of the 22% tax bracket. It can come up relatively quickly if you're not watching out for it!

Paying taxes on a Roth IRA conversion

Make sure your client has a source of funds outside of their IRA to pay taxes on the Roth conversion. If they need to use funds from their IRA, that amount is taxable and potentially subject to the 10% early withdrawal penalty if they're under the age of 59½. It creates a much larger hurdle that is difficult to overcome. If the client needs to use their IRA to pay taxes, it's unlikely a Roth conversion will make sense.

In the right circumstances, a Roth IRA conversion can be a powerful tool to build wealth. It's important to evaluate each client's situation individually to determine whether or not a Roth IRA conversion would benefit them.

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