Retirement Planning

Should You Consider a Roth IRA Conversion?

Anyone with tax-deferred retirement accounts can convert to a Roth IRA, but conversion comes with a cost — you have to pay income taxes.

Roth IRAs are retirement savings accounts that receive after-tax contributions, grow tax-deferred, and can provide tax-free income during retirement if certain conditions are met. Earnings that have accumulated tax-deferred are distributed only after all contribution dollars are withdrawn and may be taxable or income-tax free depending on your circumstances.[1]

Lower income tax rates today can make Roth conversion more attractive if you anticipate being in the same or higher income tax bracket in retirement. Predicting what tax rates will be when you retire can be difficult the further you are away from your retirement date. Before deciding to convert, make sure you review the benefits of the Roth IRA and other important factors that could impact your decision.

Roth IRAs provide:

- **Tax and penalty-free access to Roth contributions during your lifetime.** You may withdraw your after-tax annual contributions at any time, for any reason, without tax implications. However, if converted amounts are withdrawn in the first five years after a conversion and you are younger than age 59½, a 10% IRS early withdrawal penalty may apply.

- **Tax-free income after age 59½ if you have had the Roth IRA for at least five years.** The five years begins with your first contribution to the Roth IRA. This includes conversion contributions and rollover contributions from Roth account balances in your 401(k), 403(b), or 457(b) to a Roth IRA.

- **No required minimum distributions (RMDs).** You will never have to take distributions from the Roth IRA during your lifetime if you don't want to.

- **Tax-free access for beneficiaries after your death.** Roth IRAs can be a tax-efficient way to transfer your wealth to your heirs because they generally provide tax-free income to the beneficiaries that inherit them.

[1] Tax-free distributions of earnings are available after five years if you are age 59 ½ or older, disabled, receiving a first-time home purchase withdrawal ($10,000 lifetime limit), or when paid to a beneficiary after your death. State income taxes may apply, even in situations where Roth IRA distributions are exempt from federal income taxes. A 10% early withdrawal penalty tax may also apply when distributions of converted assets are taken within five years of a conversion contribution or when a non-qualified distribution is taken if you are younger than age 59 ½, unless certain exceptions apply.

Factors to Consider Before Converting

- **Beginning in 2018, the decision to convert is final.** Conversions create taxable income for the calendar year in which the conversion is completed. Any conversion in 2018 or later years is final.

- **Partial or systematic conversions can provide more tax control.** To help keep taxes under control, you may also want to consider converting only a portion of your IRA assets or systematically converting a certain amount or percentage over a period of years. One common strategy is converting amounts that keep you within your current income tax bracket.

- **Convert in years when your investments are undervalued.** Because you are not required to sell your investments to convert them, you may want to consider converting only those investments that may currently be undervalued.

- **Conversions do not satisfy RMDs.** If you are subject to required minimum distributions and you consider converting your retirement accounts to a Roth IRA, you must take any RMD for the current year before converting. RMDs cannot be converted to a Roth IRA and even though a conversion may be treated as a taxable distribution from your traditional IRA, it does not satisfy your RMD.

- **Converting non-deductible contributions can create taxable income when funding through the "back door".** If you have made after-tax (non-deductible) contributions to your traditional IRA, keep in mind that all IRA accounts you own are treated as one when determining the taxable amount of a conversion. Annually funding a non-deductible traditional IRA and immediately converting it to a Roth IRA is sometimes referred to as funding a Roth IRA through the "back door". Even if held in a separate account, you cannot selectively convert your non-deductible contributions. Other taxable IRA balances, such as earnings, deductible contributions, or rollover contributions, would be included in a pro-rata calculation of the income taxes due.

- **Plan to Roth IRA conversions can be accomplished through direct rollovers from your employer.** If you have separated from service, retired or met another distributable event from your employer's retirement plan, you can complete a conversion to a Roth IRA through a direct rollover of the taxable amounts in your plan, such as employee pre- tax contributions or employer contributions.

- **In-plan Roth Conversions are available through some employer retirement plans.** If you are still working and your employer offers designated Roth accounts in your 401(k), 403(b), or 457(b) plans, they may also provide the ability to convert your pre-tax balances to a Roth account within the plan. Keep in mind that unlike Roth IRAs, the value of these designated Roth accounts is included in the plan's RMD calculations. They are not required to offer this option so check with your plan's administrator to see if this option is available to you.

Ask Yourself These Questions Before Converting

- **Do you expect tax rates to increase over time?** If you do, converting now may help you reduce the overall taxes you pay. Although you pay income taxes at the time of the conversion, you typically receive tax-free withdrawals – which include the earnings on your converted balances – in retirement when you are more likely to need income. Distributions taken from other types of IRAs, 401(k)s, or other employer-sponsored retirement plans during your retirement years are generally taxable.

- **Do you expect to be in the same or higher tax bracket after retirement?** Even if tax rates remain the same, if you expect your tax rate to increase over time, converting now can provide an opportunity to have more tax diversification in the future.

- **Do you have non-retirement account funds available to pay the income tax liability that would result from the conversion?** If you don't, then converting to a Roth IRA may not be a good strategy for you to consider right now.

- **Do you intend to use your IRA assets before age 59½?** Roth IRAs provide tax and penalty-free access to contributions prior to age 59½, but conversion contributions must be left alone for five years or the 10% penalty may apply to the Roth IRA distributions.

- **Will you need your IRA to pay for living expenses during retirement?** The closer you are to using your IRA for income, the less attractive converting to a Roth IRA may be. With a traditional IRA, you pay income taxes only on the income you need to take each year. By converting to a Roth IRA, you are electing to pay taxes up-front. One of the key benefits of a Roth IRA is the compounding of earnings that can accumulate over time and be withdrawn income tax-free. If you won't benefit from the accumulation of earnings, then converting to a Roth IRA may not be the best strategy for you.

- **Is leaving a legacy an important part of your financial planning goals?** If it is, then converting to a Roth IRA can be very attractive because beneficiaries that inherit Roth IRAs from you after your death can receive tax-free income. If they inherit other types of IRAs, 401(k)s, or other employer-sponsored retirement plans, they will generally pay income taxes on the income they receive.

- **Do you want the option, but not the requirement, to use the IRA or retirement accounts for income during your retirement?** If you do, remember that Roth IRAs do not have RMDs. Although, converting to a Roth IRA before required minimum distributions begin will cause income taxes to be paid up front, it prevents forced withdrawals that are mandated for other types of retirement accounts that have RMDs. Converting gives you the option to use your Roth IRA when or if you need to.

The decision to convert or not convert is as unique as you are and is something that should be considered carefully and in consultation with your tax professional. If you are considering a Roth IRA conversion, ask your financial advisor for a Roth IRA Conversion Illustration. ■

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