What to Consider Before Converting to a Roth IRA

Presented by Warren Wealth Associates

Roth IRAs can be extremely efficient retirement savings vehicles because they're funded on an after-tax basis and, as a long as certain requirements are met, distributions are free of tax and penalty.

You can fund a Roth IRA in one of two ways: via annual Roth contributions or by converting assets from a qualified plan or another type of IRA you already own. Although annual Roth contributions are subject to modified adjusted gross income limits, Roth *conversions* are not. It's one of the main reasons you might decide to convert assets to a Roth IRA.

Just because you can, though, doesn't mean you should. Here's what to consider before converting to a Roth IRA.

Key Factors: Tax Brackets and Time Horizons

There are two important factors to consider before moving forward with a conversion: your current tax bracket and a reasonable estimate of what it will be when you retire.

If you think you are likely in a lower tax bracket now than you will be in the future, a conversion may be the right choice. Because distributions of pretax assets from an IRA or qualified plan increase taxable income in retirement, converting the assets today could result in lower taxes than you would otherwise incur on distributions down the road. Sure, current taxable income increases, but the assets in the Roth account now have a number of years to grow, and you can distribute them tax free in retirement. Generally, Roth conversions are best suited for younger individuals with pretax assets in another type of IRA or qualified plan from a previous employer.

Another important question to ask is, "How much time do these assets have to grow?" You need to know when you intend to start withdrawing the nest egg (your time horizon) because the longer the assets can grow in the Roth account, the more a Roth conversion makes sense. Even if you think you will be in a *lower* tax bracket by the time you withdraw the funds, the accumulation of earnings over an extended period and the ability to withdraw that growth tax free may justify paying taxes on a Roth conversion today.

Managing the Mix of Pretax and After-Tax Contributions

The next matter is figuring out how much you want to convert—a decision that will depend largely on tax consequences. If all of your IRA assets consist of pretax contributions and earnings, it's fairly straightforward: all of the assets converted to a Roth IRA will be taxable.

It works differently when you have a mix of pretax and after-tax IRA assets. Unfortunately, the IRS does not let you pick and choose which assets you want to convert. In other words, if you have $50,000 in pretax assets and $50,000 in after-tax assets in your IRAs, you can't convert only the after-tax portion as a tax-free conversion. The IRS views all IRAs you own as one big bucket of pretax and after-tax funds: the amount of a Roth conversion that will be tax free is determined by the percentage of your *total* combined IRA balances that represents after-tax contributions. To determine this pro rata calculation, the IRS considers pretax and after-tax balances in all of your traditional, rollover, SIMPLE, and SEP IRAs (qualified plans like 401(k)s and inherited IRAs are not factored into this calculation).

> **Example:** Bob has two IRAs worth a total of $100,000. IRA No. 1 is made up of $60,000 in pretax money, and IRA No. 2 has $40,000 in after-tax money. Bob decides to convert $10,000 from IRA No. 2 to a Roth IRA. In this scenario, $6,000 will be included in his taxable income, and $4,000 will be converted tax free because 40 percent of his total IRA balance represents after-tax contributions.

This is a simplified example. Be sure to work with a tax advisor to help with determining the correct pro rata calculation and with filing IRS Form 8606, which is required if a Roth conversion consists of any after-tax contributions. You'll also want to make the advisor aware of all your existing IRA balances, so you can accurately understand how a Roth conversion will affect your taxable income.

The Long-Term Effects: RMDs and Legacy Planning

Another reason to look closely at Roth conversions is they can serve as a way to eliminate required minimum distributions (RMDs) once you turn 73—as long as you pay tax on the IRA assets before retiring. Converting pretax assets on a onetime or periodic basis before reaching RMD age can help you spread some of your tax liability over a number of years rather than experience a spike in your taxable income once RMDs begin. You may find that later in the calendar year is a better time to determine if a conversion makes sense, as that's when you tend to have a more accurate picture of your income for the year. In addition, because RMDs from Roth IRAs are not required while the original account owner is alive, you could realize more long-term growth in the account well past age 73.

But then what? You may be wondering what happens when you pass away. Spouse beneficiaries have the ability to avoid RMDs on their inherited Roth assets by moving the funds into their own IRA. But non-spouse beneficiaries of Roth IRAs will either be subject to annual RMDs or will need to deplete the assets fully within 10 years of the decedent's death. Will those distributions receive the same tax-free treatment as they would if made by the original owner? Yes. As long as it has been at least five years since the decedent first contributed to the Roth, beneficiaries' RMDs will be tax and penalty free. So, Roth conversions may be viewed as an attractive option if you want to leave a tax-free legacy to your heirs.

Account Owners Beware: Recharacterizations No Longer Allowed

Prior to 2018, you could use what is called a recharacterization to undo a previously processed Roth conversion. This reversal option benefited those who did a taxable conversion, saw the value of the Roth account decrease, but were still responsible for taxes on the initial conversion amount. A recharacterization eliminated the tax liability on the conversion by moving the funds back to the delivering IRA or qualified plan.

The Tax Cuts and Jobs Act did away with this correction method as of January 1, 2018. So, it's important to understand that if you elect to convert assets to a Roth IRA, you can't reverse that decision—and you'll owe any taxes incurred in the year the conversion is processed.

It's All About Facts and Circumstances

Your unique set of circumstances will determine whether a Roth conversion is merited. It's important to identify the factors that will affect the tax implications of the Roth conversion now, such as your current tax bracket and the specifics of your IRA portfolio. At the same time, you may want to work with your advisor to develop a detailed forecast of what your future income will look like, determine when you plan to start drawing down your retirement savings, and decide if you view providing tax-free income to your beneficiaries as a priority.

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