Is a Roth Conversion Right for You?

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Introduction

Everyone wants to have a stress-free retirement, right? But making that a reality isn't something is going to arrive without effort. But actions speak louder than words. Achieving success in retirement requires time. It requires effort and discipline, not bubblegum and duct tape.

Building that confidence to your successful retirement means that you've got to start as soon as possible. The best time to start is when you're young. But if you haven't done anything or if you feel like you're under prepared, resolve to get started today, because there are a lot of moving parts you need to have working in concert with one another, and the longer you wait, the harder it becomes.

Thinking about all the pieces of a good retirement strategy, can sometimes be overwhelming, and that's one of the biggest reasons that people don't take action. There are lots of things to consider. Am I saving enough? When do I need to take SS? And would a Roth benefit me or not? This report is going to focus on that third question……..Is a Roth conversion right for you?

IRA and Roth IRA Basics

IRAs are one of the most popular ways to save for retirement, because they enable you to invest your money in a way that also brings significant tax advantages.

There are a couple of different types of IRAs, each with different strengths. So, it's important to know which type is right for you. A Traditional IRA? or a Roth IRA?

While both types help you save for retirement, they each come with different advantages and disadvantages. So, you should weigh the pros and cons of each in order to decide which is more suitable for you. But before we do that, here's what a Traditional and a Roth IRA have in common.

1. Both are designed to help you save for retirement.
2. Both usually come with a wide range of investment options.
3. Both have the same annual contribution limits
4. Both come with substantial tax advantages. It's when these tax advantages apply that Traditional and Roth IRAs differ.

With a Traditional IRA, all the contributions you make are usually tax deductible but your distributions are considered ordinary income and may be subject to income taxes. With a Roth IRA, your contributions are not tax-deductible, but your distributions are.

So how do you choose between the two? The answer is by following this simple rule of thumb: If you expect your tax rate in retirement to be lower than it is now, go with a Traditional IRA. That way, you can skip paying taxes on your IRA while your tax rate is higher, and then pay less in taxes once your tax rate is lower. On the other hand, if you expect your tax rate to be the same or higher during retirement, a Roth IRA is likely a better choice.

What are some of other the differences between a traditional and a Roth IRA?

1. Anyone can contribute to a Traditional IRA no matter how much income they make. If your income exceeds a certain limit, you may not contribute to a Roth IRA. As of 2023, the limit is $129,000 if you are single and $204,000 if you are a married couple filing jointly.
2. With a Traditional IRA, you must withdraw a minimum amount from your IRA every year following the year you reach age 73 and these withdrawals may be subject to income tax. Roth IRA owners do not have to withdraw money from their accounts if they don’t want to, even after retirement.
3. Contributions to a Traditional IRA may be tax deductible, but distributions may be subject to income taxes. Contributions for Roths are never tax deductible, but distributions are tax-free.

Taking an Income

One of the best ways to maximize withdrawals is to minimize the income taxes you owe on them. For the best tax outcome, it is important to coordinate withdrawals between taxable brokerage accounts and pre-tax accounts such as IRAs and 401(k)s.

Conventional wisdom suggests that taxable investment accounts should be exhausted first, then tax-deferred accounts, and finally tax-free accounts. That strategy allows tax-deferred and tax-free accounts to continue to grow. But there could be a downside to the traditional approach. Being too good at tax deferral could result in the IRA growing so large that future withdrawals could actually drive the retiree into a higher tax bracket. So, the optimal approach is actually to preserve the tax-preference value of retirement accounts ***and*** to fill the tax brackets early on, by funding retirement *spending* from taxable investment accounts by doing systematic partial Roth conversions of the pre-tax IRA to fill tax brackets in the early years. If withdrawals are taken simultaneously *from both* types of accounts a retiree's savings will last longer. By taking the partial distributions from the IRA each year, the distributions can occur at the lower tax bracket.

One smart method is to systematically convert portions of any traditional IRAs into Roth IRAs prior to retirement. The goal is to prevent you from being pushed into a higher tax brackets when it's time to start taking your RMD, by paying Roth IRA taxes now rather than traditional IRA taxes later when they may be in a higher tax bracket.

On the other hand, retirees who continue to work at least part-time may want to withdraw funds from their Roth IRA account because their income now is presumably higher than it will be when they aren't working at all.

Call us at 1800-277-0025 to see how we use our Retirement Planning tool to assist with this.

How do Roths work in regards to heirs

Retirees that wish to pass along their assets to heirs have additional tax consequences to consider. In those situations, you may need to delay withdrawals from a Roth IRA because those funds would pass to heirs tax-free. Other inherited assets such as those from a 401(k) or rollover IRA are taxable to the heirs whose tax rates may be higher than that of the retiree. In that case, the retiree many want to spend down his or her tax-deferred assets to remove them from the estate.

Retirees who want to minimize the tax burdens faced by heirs should also look at deferring withdrawals from taxable assets with large capital gains. Those assets, such as individual stocks, will get a step-up in value prior to the tax bill being determined. The result is that heirs will pay a much lower tax on capital gains than the retiree because the basis of those gains will be the value of the asset when the retiree died, not when they were first purchased.

The tax consequences – and options for minimizing them – are complex and can be hard to understand. The rules are also fluid and can change at any time. The right strategy depends on a variety of factors, including your age, the value of your accounts and the components of your estate.

For example, converting funds from a traditional IRA to a Roth IRA could save one person money on her taxes but actually increase the taxes owed by someone else. Proper sequencing of withdrawals – which accounts to tap and in what order – is also crucial to maximizing your savings but can be complicated and difficult to execute. The wrong choices can profoundly impact your financial future, as well as those of your heirs.

Before making any significant decisions about spending in retirement, you may want to work with your financial advisor and/or tax specialist before you begin taking withdrawals from your savings. And the earlier you put a plan in place, the greater the likelihood of it succeeding.

Is a Roth Conversion right for me?

We all hear about the benefits of a Roth IRA compared to a traditional or a regular IRA. And it really seems like the conventional wisdom is that everyone should either have a Roth IRA, or they should convert their regular IRA to a Roth. What I've found over the years is that there are lots of times when a Roth conversion makes sense, and there are times where it could be a huge financial mistake.

As I was saying in the first segment, what makes a Roth more appealing than a traditional IRA?

With a traditional IRA, you only pay tax when you take money out. And any withdrawals that you take out are taxed as ordinary income, so you don't get the benefit of a lower or potentially lower capital gains tax. But with a traditional IRA, you get to deduct your contributions from your income before you calculate your tax. You get no deduction for contributing to a Roth account. But the real benefit of the Roth account comes down the road when you want to take money out because all those gains that you accumulate in your Roth over the years, all the interest, all the dividends…..they're never taxed when you take that money out. That's a huge deal and it's one of the most significant differences between a traditional IRA and a Roth IRA. Another benefit I mentioned in the first segment of a Roth IRA, is that you don't have any required minimum distributions. As a result, if you don't need that income, you can just leave it alone to gain even more money over time. A third benefit that we were just discussing in the aldt segment is that when you pass away, if your beneficiaries take that Roth account, then they get the benefit of allowing that money to grow tax free and take that money out tax free as well. So, from an estate planning standpoint, it can be a great tool. It can certainly be a great gift for your kids or grandkids or friends or relatives to inherit and not have to worry about a tax liability. When it comes to making a decision about a Roth conversion, you have to count the costs. This is critical, and that's not always an easy thing to do because there are hard costs like taxes and there are soft costs….things like personal goals or the emotional side.

Here's an example. I recently I had a meeting with Barry. He had saved up about $600,000 in his IRA and he is now 65. He's getting ready to retire in a year and he doesn't expect to need any of his IRA during his retirement, since his pension and social security are more than enough to live on in He's planning to leave the entire IRA to his daughter, assuming that he doesn't need it for long-term healthcare or something like that. So he figured that he wanted to do a Roth conversion, and as a result, he thought he was going to just

convert the whole thing in one year. When we actually did the math, I showed him that he's going to have to write a check to the IRS for $225,000. So it's important to develop a strategy to get that IRA money converted to a Roth.
Another issue is that if you earn too much money, then your Medicare is going to jump up for a few years. So it's very important to look at the big picture. So I told him if we took that $600,000 and we broke it up into much smaller chunks over the next eight years or so, he may be able to save over $100,000 in taxes, accomplish the same thing, and then have more money left over in case he needs long-term care in his lifetime, or for his daughter to inherit. Now, that's a great legacy, and Barry was thrilled about that option. You see, it's all about the planning.

But Barry's not alone in his thinking. He almost made a significant costly financial mistake that he may never have been able to recover from simply by missing one small but significant step.

Earlier in this report, I reviewed some of the key characteristics of a Roth IRA, like tax deferred growth, tax-free withdrawals, and tax-free is better than tax deferred that you get with a regular IRA.

Also, there's no required minimum distributions with a Roth, and a beneficiary can inherit a Roth tax free. These are all great reasons to have a Roth. But does that mean that you should take your traditional IRA and convert the whole thing all at once?

It's important to understand the process in order to make a well thought out informed decision. This is where the planning comes in. And remember every situation is going to be different, but the concepts are the same.

The first thing you need to do when you're thinking about doing a Roth conversion, is you need to take a look at your sources of taxable income. That's why if you're still working, you've got to be very careful because your salary is a taxable amount, and if you do a Roth conversion, then that Roth conversion could bump you into a higher tax bracket. So if you're single with taxable income of $150,000, you're in the 24% tax bracket, you've got about a $20,000 buffer before that bracket jumps up to 32%. Now, if you decide you want to do a Roth conversion on a $100,000 in one year, you're going to possibly pay $32,000 on most of that money that could cost you an extra $26,000 in taxes. But instead, if you convert $20,000 a year for five years, you'll accomplish the same goal, but keep your tax costs down in the 24% tax bracket.
Remember, the success of a Roth conversion depends on whether or not you believe taxes are going up. Personally, I believe that over the next 30 years, which for most baby boomers, that's your entire retirement life, we are going to see taxes go up.
Look no further than 30 trillion in debt on the US balance sheet. But for you, when you convert a Roth, the tax cost you pay today has to be recouped by tax-free growth and tax savings in the future. So you've got to take that into consideration. And the bigger the tax cost today, the less likely you are to see the benefits in the future. That’s what you should tell your kids and your grandkids about the benefits of a Roth, especially over a 30 to 40 year working career. Roth IRAs have only been around since 1997 and Roth 401K only started in 2006, so they haven't been around for the entirety of most baby boomers working lives. Not only that, but it took some time for them to take hold. And for that and many other

reasons, that's why a lot of baby boomers didn't really use them.

So you have to ask yourself the question…..Hey, is this really right for me? It sounds great. Tax free is always better than tax deferred, but if you need the income from your traditional IRA to fill the income gap in your retirement a Roth conversion probably doesn't make sense for you since you're going to be spending that money. It takes time to recoup not only the tax cost, but the gains to make it really a beneficial transaction.

And I've also helped many people convert some IRA money tax free. So how do you do that, you might ask? Well, here's a situation. If you retire at 65 and you've got some savings that you can live on for the first few years before you start Social Security, or if you start Social Security, and that's plenty for you to live on, you may be able to take some of your IRA, do a Roth conversion and stay below the tax threshold, which means you have all the benefits of a traditional IRA, meaning tax deductions on your contributions, And in this case, with the Roth conversion, you got a tax free withdrawal.

Effectively, it's the best of both worlds. But this is one of those things where I would tell you don't try this at home. You've got to know how to do the calculations. You got to determine if there is any tax cost and what is it going to be?

And if you're fortunate enough to be in that window, that corridor of taxes on the financial spectrum, then you could even benefit by doing a tax-free Roth conversion.

So make sure that you talk to somebody who understands the implications. Just because a Roth gives you tax-free benefits down the road doesn't mean that a Roth conversion is the right thing for everyone, and doing it the wrong way may cause you to pay tons more in taxes, which would only defeat the purpose and possibly ruin your retirement.