Roth Conversions: Is Now the Time?

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Retirement Insights

If you had the opportunity to invest money today and never pay income tax on its growth, would you be interested? What if this tax-free growth could extend ten years beyond your surviving spouse's lifetime? Although this may sound too good to be true, it describes investing with a Roth IRA. In order to benefit from this preferential tax-free growth, you must invest after-tax dollars that have been set aside in a retirement savings account, such as an IRA, 401(k), or similar defined benefit plan. Given the current tax climate, and the potential for taxes on ordinary income to increase in the foreseeable future, now is the opportune time to consider converting to a Roth IRA.

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Roth IRA Advantages

Tax-Free Growth and Distributions: Assets inside a Roth IRA grow tax-free, similar to a traditional IRA. The significant difference between the two is the taxation of distributions. Traditional IRAs are tax-deferred savings vehicles that allow assets to grow tax-free with the distributions taxable as ordinary income. Traditional IRAs are considered "tax-deferred," since investors are allowed to defer taxes until money is withdrawn from the IRA. In contrast to a traditional IRA, amounts contributed or converted to a Roth IRA are after-tax dollars that

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can always be withdrawn tax-free. Similar to a traditional IRA, you need to remain aware of the potential for a 10% early withdrawal penalty for withdrawals on converted amounts if you are under age 59½. With a Roth IRA, the growth beyond the contributed or converted amounts will be tax-free as long as they are part of a "qualified distribution." A distribution is considered qualified if you established a Roth at least five years ago and are either over age 59½ or disabled. If you inherited the Roth IRA, the distribution will be a qualified distribution as long as the five-year waiting period has passed since the decedent established their first Roth IRA. Years of tax-free growth followed by tax-free distributions make Roth IRAs an investment vehicle of choice for many.

No Required Minimum Distributions (RMD): Another attractive feature of a Roth IRA is the absence of RMDs. During your lifetime, as well as during your surviving spouse's succeeding lifetime if they are named as beneficiary, there are no RMDs that must be taken from a Roth IRA. This is an important distinction from a traditional IRA where you must begin taking annual RMDs at age 73, which are taxable as ordinary income. In most cases, non-spousal beneficiaries inheriting a Roth IRA will not be subject to annual RMDs but will instead be required to withdraw all assets from the Roth IRA before December 31 of the tenth year following the Roth IRA owner's death. These withdrawals will be tax-free.

Who Should Consider Converting

Roth IRAs' significant advantages can be attractive for many individuals, but specific circumstances can make a Roth IRA even more compelling for some. Individuals who believe one or more of the following circumstances apply to them should consider a full or partial Roth conversion:

Federal or State Taxable Estates: Individuals whose estate will be subject to state or federal estate taxes should consider converting to a Roth IRA to minimize those taxes. Income taxes paid on the conversion decrease the decedent's estate, which results in both lower estate taxes at death and the ultimate beneficiary receiving an income tax-free asset. Without the conversion, estate taxes would be due on the embedded income tax liability related to the traditional IRA, plus the ultimate beneficiary would be subject to income tax on amounts withdrawn from the traditional IRA. Without the conversion, the result is that estate taxes are due on the portion that is ultimately an income tax liability.

Increasing Income Taxes: If you anticipate being subject to higher income taxes during retirement or in future years, you should consider converting all or a portion of your traditional IRA to a Roth. This is also true if you believe your beneficiary will be subject to a higher ordinary income tax bracket than you are currently. It is important to note that Roth conversions are not an all or nothing. Conversions are often accomplished over a number of years, with amounts converted based on marginal income tax rates and the owner's appetite for paying taxes in a given year.

Non-IRA Assets to Pay Income Taxes: A Roth conversion is most efficient when non-IRA assets are available to pay conversion-related income taxes. If you do not have outside assets available to pay the tax liability, you trigger additional income

tax liability by taking taxable withdrawals to pay the conversion tax liability. This, in effect, leaves fewer assets to enjoy tax-free growth in the Roth. An additional word of warning if you are under age 59½: You will also be subject to a 10% penalty on the amount withdrawn from the traditional IRA to pay the income taxes, since those amounts are neither converted nor rolled over.

Do Not Need IRA Assets to Support Lifestyle: If you do not anticipate needing the assets in the traditional IRA to support your lifestyle, then converting to a Roth IRA can be compelling as it creates an income tax-efficient asset for wealth transfer.

Longer Time Horizon: The longer the time horizon for your Roth, including your surviving spouse's life and the ten years following his or her death, the greater the tax-free growth and corresponding benefit from the conversion.

Desire to Diversify Tax Attributes: Being able to manage future income recognition, because you have a choice as to whether you trigger income tax when you access your retirement savings, can be a significant benefit. Having both traditional and Roth IRAs can allow you to manage income recognition and may help you avoid the higher costs of Medicare's income-related monthly adjustment amount.

Depressed Market Values: An ideal time to convert to a Roth is when asset values are depressed or you expect strong market growth. Although it is likely not worth waiting for a market correction, when one occurs, it presents an ideal time to convert.

Non-Spousal Beneficiary: Under the current rules, most non-spousal beneficiaries must take all of the assets out of an IRA by the end of the tenth year following the owner's death. For traditional IRAs, this acceleration often leads to higher income taxes during those years, making Roth conversions today are even more advantageous at the point the IRA vehicle passes to a non-spousal beneficiary.

Trust Beneficiary: It is even more compelling to convert to a Roth IRA if your plan passes IRA assets to a trust after the surviving spouse's death. A properly drafted trust named as the beneficiary of a Roth IRA helps protect a beneficiary by avoiding distribution decisions that are not in the best interest of the beneficiary in order to manage income taxes triggered by traditional IRA distribution requirements. This is particularly relevant with the SECURE Act requiring all assets to be distributed from the IRA vehicle at least by December 31 of the tenth year following the original IRA owner's death for most non-spousal beneficiaries. Irrevocable trusts have significantly more compressed income tax brackets than individuals, with ordinary income of just over $15,200 being subject to the highest marginal federal income tax bracket. If you have previously named a trust as the beneficiary of your IRA asset, you should review the trust terms in order to ensure that the current provisions satisfy your goals given the SECURE Act IRA distribution requirements.

It is even more compelling to convert to a Roth IRA if your plan passes IRA assets to a trust after the surviving spouse's death

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Income level does not affect your ability to convert traditional IRA assets to a Roth IRA

Who Should Not Convert:

Unwilling to Accelerate Income Taxes: If you are not willing to accelerate income taxes, a Roth conversion is not for you.

Charitable Beneficiaries: Do not convert to a Roth IRA if you plan to pass your IRA to charity at your death. Since charities pay little or no income taxes, there is no real benefit to their receiving a Roth over traditional IRA asset.

Cash Flow Needs: If you or your spouse will need the IRA assets to support your lifestyle, particularly if you are in a lower income tax bracket, then there may not be a reason to convert.

Qualified Charitable Distributions: If you are over the age of 70 1/2, in 2024, you can distribute up to $105,000 per year for your traditional IRA directly to qualified charities and have it count as part of your RMD. If you plan to do this, you should retain sufficient assets in the traditional IRA to fund your goal.[1]

Lower Future Tax Rates: If you believe you will be in a lower tax bracket as you take RMDs, or if you believe your ultimate beneficiary will be in a lower tax bracket, then a Roth conversion may not be as compelling for you. If you plan to move to a state that does not have state income taxes that should be considered as well.

Conversion Mechanics

Traditional IRAs are converted to a Roth IRA by paying ordinary income tax on amounts converted at the time of the conversion. Amounts rolled out of a traditional 401(k) are converted to a Roth IRA in the same manner. Income level does not affect your ability to convert traditional IRA assets to a Roth IRA. If you have both pre-tax and after-tax traditional IRA assets, you cannot choose to convert just the after-tax assets but instead you must convert a prorata share of each and will be required to recognize income accordingly. If you are at an age when you are subject to RMDs on your traditional IRA, the current year RMD must be taken before any remaining IRA assets can be converted. RMDs themselves cannot be converted to Roth IRAs.

Roth 401(k)s

If you are currently working and your employer offers a Roth 401(k) option, you should consider directing all or a portion of your 401(k) contributions to the Roth 401(k). This is particularly true if you are early in your career or in a lower income tax bracket. Any employer match will be in the non-Roth portion of your 401(k), providing automatic tax diversification. If you utilize a Roth 401(k), you should consider establishing at least a modest Roth IRA in order to satisfy the five-year period noted above instead of waiting to begin that clock at retirement.

Roth IRAs

If your income levels allow, contributing directly to a Roth IRA is also recommended. Single filers with modified adjusted gross income (MAGI) below $146,000 for 2024 can make a full $7,000 contribution to their Roth IRA if they

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have employment income at least at that level, while taxpayers who are married filing jointly begin to be subject to contribution limitations when their MAGI goes above $230,000. Taxpayers over age 50 are allowed an additional $1,000 maximum contribution, increasing the maximum to $8,000.

Backdoor Roth IRA Funding

Taxpayers with MAGI in excess of the limits noted above can make a non-deductible contribution to a traditional IRA and convert the contribution to their Roth IRA under a concept known as a backdoor Roth IRA contribution. As long you do not have any other traditional IRA assets, you can carry this out without triggering additional income tax liability. If you do have other traditional IRA assets, additional taxable income would be recognized on the conversion by applying the ratio of after-tax IRA contributions in the traditional IRAs to the total value of the traditional IRAs to the amounts converted. All traditional IRAs are required to be included in this calculation.

Roth conversions are an exciting opportunity and should be evaluated in the context of your overall wealth plan. If you are interested in discussing whether a Roth conversion is right for you, please reach out to your Fiduciary Trust Officer or your tax advisor. ■

[1] Number indexed for inflation annually.

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