DOES A ROTH CONVERSION MAKE SENSE FOR YOU?

By Eric Coffman, CFP®, CKA®

Would you be willing to pay a larger income tax bill today if doing so would help you and your family to potentially save a lot in future income taxes? If so, you may want to consider converting a portion of your pre-tax IRA or retirement plan money to a Roth IRA.

Potential big tax-savings for you.

Qualified withdrawals from Roth IRAs are income tax free—which is a huge benefit. Let's consider an example. Assume that in retirement you will be in the 25% marginal income tax bracket and will need to withdraw $40,000 from your retirement accounts to augment your income. You would need to withdraw $53,000 from pre-tax retirement accounts to net $40,000. If that tax is not taken from the account at the time of withdrawal, it would need to be paid through other means come tax time.

From a Roth IRA, however, you would only need to withdraw $40,000. The extra $13,000 that would otherwise be lost to taxes each year would continue to experience tax-free growth which would strengthen and lengthen your retirement income plan.

Potential big tax-savings for your family.

Passing along Roth IRAs to your heirs will in turn allow them to take tax-free withdrawals and aid in their wealth accumulation. This is especially true since the stretch-IRA withdrawal strategy is no longer available.

Under current tax rules, a beneficiary is required to withdraw inherited IRA and retirement plan money within the first ten years instead of over their life expectancy. This results in two problems: a higher income tax bill paid over a shorter number of years and lost tax-deferred growth that could have been enjoyed over many decades. Inheriting a Roth IRA could allow your heirs to take tax-free withdrawals which solves the tax problem. Since they may no longer stretch withdrawals over their lifetime, inheriting Roth IRAs may help your heirs replace some of the tax-deferred growth they would have otherwise enjoyed.

A Few Things to Consider:

- Converting pre-tax retirement money into Roth money will create taxable income.
- Three separate five-year withdrawal rules apply situationally when taking withdrawals from different types of Roth IRAs. Thus, it is prudent to only convert money that you know you won't need to use within the next five years. While exceptions exist, violating these withdrawal rules will most likely result in a tax-penalty.
- Your company retirement plan may not allow for in-plan Roth conversions, but it may be possible for you to rollover money to an IRA and then convert.
- There are no income restrictions when making a Roth conversion.
- A savvy strategy is to make the conversion during a year in which you may offset a portion of the income tax with another large deduction such as a contribution to a charity or a donor advised fund.

Consult with your wealth advisor and tax professional to find out if a Roth conversion makes sound financial sense for you.

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