Should I Do a Roth Conversion?

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A Roth Individual Retirement Account (IRA) can be a great savings tool in most retirement strategies. Since there are restrictions on who can contribute and how much, few investors utilize these accounts and those that do often underuse them. Unlike a 401(k), where contributions can be automated from a paycheck, Roth IRA contributions must be planned by the investor. This requires more foresight and preparation.

For the 2023 tax year, individuals with Modified Adjusted Gross Income (MAGI) less than $138,000 ($218,000 if married and filing jointly) are eligible to contribute up to $6,500 to a Roth IRA. Those with higher MAGI may still be able to contribute, but the amount will vary.

The good news is there are other ways to get money into a Roth IRA if you're over these income limits. One option is via backdoor Roth contributions (which we've spoken about in the past). Another strategy is a Roth conversion.

What Is a Roth Conversion?

A Roth conversion is the process of moving money from a Traditional or Rollover IRA into a Roth IRA. This process has no age requirements, income restrictions, or limitations on how much you can convert. Each dollar moved from a Traditional or Rollover IRA to the Roth IRA is added to ordinary income in the year it was converted. Consequently, you'll be required to pay income tax on all dollars that are converted to a Roth IRA by the end of that tax year.

We typically advise that individuals take advantage of Roth conversions in years when their income is suppressed, and they fall into lower tax brackets. This allows you to pay taxes on the converted money at a lower rate, distributing it tax-free in the future.

What Should I Consider Before Doing a Roth Conversion?

Here are four factors to consider when deciding if a Roth conversion is appropriate for you:

Tax Planning

If you are confident that your tax rate today is lower than it will be in the future, now may be a good time to consider a Roth conversion. However, there is more to examine than just federal tax brackets.

You should give careful consideration to whether this will affect the amount you pay and receive from income-based programs. For instance, Medicare has Income-Related Monthly Adjusted Amount (IRMAA) surcharges if you pass a certain income threshold. This is a surcharge that increases your monthly Medicare premiums.

An increase in income may also increase your other tax rates. Capital gains have completely different tax thresholds than ordinary income. Therefore, more income may not increase your ordinary income tax but may push you into the next capital gains tax bracket.

Another consideration for high-income earners is Net Investment Income Tax (NIIT). Along the same lines as capital gains, NIIT has different income thresholds than the federal tax or capital gains tax brackets. Before doing a Roth conversion, it’s imperative to research the applicable tax brackets and understand how more income may affect the entirety of your taxes.

Timeline

The IRS has a five-year rule restricting how soon you can withdraw from your Roth IRA after a conversion. Pulling converted savings early may result in a 10% penalty. The five-year clock starts on January 1 of the year you make the conversion, even if you make the conversion on December 31 of that year.

It's important to note that the five-year rule only applies to the converted amount and not to the entire Roth IRA account. If you make multiple conversions, each conversion will have its own separate five-year period. However, the five-year rule is waived in some circumstances, such as withdrawing funds for a first-time home purchase or certain medical expenses.

Required Minimum Distributions

When planning for retirement, be sure to consider the impact of Required Minimum Distributions (RMDs) on your income. Once you turn age 73, you'll be required to take a calculated amount of money from your Traditional or Rollover IRA each year. If you've estimated how much your RMD will be in retirement and know you will not need the extra income, a Roth conversion may be in your best interest. By converting your money, you will reduce your projected RMD.

Alternatively, those who don't need their RMDs and are charitably inclined can choose to gift the money directly to an eligible charity through a Qualified Charitable Distribution (QCD) from their Traditional or Rollover IRA. This option allows for tax-free charitable giving and is also non-taxable for the charitable organization. In other words, you and the eligible charity will NOT have to pay taxes if you donate directly from a Traditional or Rollover IRA. If you plan to utilize this strategy, a Roth conversion may not be in your best interest.

Beneficiaries

If your goal is to pass on wealth to your beneficiaries, you'll need to evaluate precisely where the funds will go. If your beneficiary is a family member or friend, a Roth conversion might be most beneficial for them. Converting money to a Roth leaves you with the tax bill, thus giving your beneficiaries tax-free growth and withdrawals.

If you plan to leave your life savings to charitable organizations, it may make more sense to leave your money in a Traditional or Rollover IRA. These IRA dollars are non-taxable for the charitable organization. Therefore, the assets are already tax-free for them, and a conversion would result in you paying unnecessary taxes.

How Do I Pay for My Conversion?

When making a Roth conversion, you have the option of withholding taxes on the withdrawal or paying the taxes from other sources (such as bank savings). Withholding taxes often results in a smaller conversion or higher overall tax liability. We often recommend you pay the estimated tax amount from bank accounts or other investment assets to maximize your conversion. You can pay the estimated tax quarterly or at the end of the tax season. Which route you should choose heavily depends on your circumstances. We recommend consulting with an accountant to receive personalized advice on how and when you should pay taxes.

The Bottom Line

When deciding whether to do a Roth conversion, understand how it plays into your long-term financial plan. Your decision today can affect your future financial planning and tax strategies. While Roth dollars can provide more flexibility with your withdrawals in retirement, Roth conversions don't make sense in every strategy. Check out our free visual recap on when it makes sense to include a conversion in your financial plan.