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Reducing Taxes with a Roth Conversion

Would you like to reduce your taxes in retirement and/or leave more money to your children? What if you could do both? Below we discuss certain situations where converting your Traditional IRA to a Roth IRA might make sense.

If You Don't Need Your Required Minimum Distribution (RMD):

As you probably know, if you have investments in a Traditional or Rollover IRA, you have to begin taking RMDs at age 70 ½. Based on current IRS lifetime expectancy tables, that means you can anticipate withdrawing roughly 4% per year of your IRA balance as your RMD. Whether you need it or not, this withdrawal will be taxed as ordinary income.

We sometimes hear from clients that they wish they didn't have to start taking their RMD at 70 ½. They don't really need it to live on and don't want to pay the income taxes required. In some cases, the RMD can even cause them to bump up to a higher marginal tax bracket.

However, if you had those same investments in a Roth IRA instead, you would not be required to take any RMD, thereby reducing your taxable income in retirement.

So, how do you get those investments moved from your IRA to a Roth? It's called a Roth Conversion. The only catch is that the year you convert your IRA to a Roth, you have to pay taxes on the total amount you converted.

Here's an example:

Let's assume you are 65, in the 40% tax bracket, and you don't need any of your RMD for your living expenses. If you convert a $500,000 IRA to a Roth this year, you will have to pay $200,000 in extra taxes. (Not very appealing, I know.) Although, if you keep the investments in a traditional IRA, you and/or your heirs would still pay taxes – and the cumulative effect could be higher than the one-time conversion amount. For example, if you live to age 90, stay in the 40% bracket and earn an average 7% return on your IRA, you could pay approximately **$300,000** in taxes on the RMDs taken during your lifetime.

In fact, the real benefit of the conversion comes when this account gets passed to your heirs. In this example, assume that your child inherits the account at age 50. With an Inherited Roth IRA instead of an Inherited Traditional IRA, it is estimated that they could withdraw an additional **$2.1 Million** over their anticipated lifetime without paying any income taxes!

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If You Will Need Some of Your RMD:

Many of you will need to take some, if not all, of the RMD upon turning 70. That being said, if you were able to retire before age 70, and for a few years found yourself in a low tax bracket, partially converting can still make sense. In this case, you may want to adopt a multi-year conversion strategy. This approach will allow you to convert just enough each year to stay within your current low tax bracket. You may not get all of the IRA converted by 70 ½, but your future RMD will be lower and you can supplement with tax-free Roth withdrawals as needed.

A Few Additional Considerations to Keep in Mind:

- For maximum tax reduction, the tax due on a conversion should be paid from an outside source (i.e. not from the IRA balance).
- The younger you are when you convert, the more time the Roth account has to accumulate tax-free and recoup the tax you paid on the conversion. For example, a 35 year old converting $50,000 now could feasibly expect approximately $120,000 more in distributions during retirement.
- The lower your tax bracket when you convert, the quicker you "break-even" on the Roth conversion.
- If your investment value declines significantly in the same year you convert, you can "undo" (re-characterize) the conversion to avoid paying taxes on the previously higher value.
- Both Traditional IRAs and Roth IRAs are still considered part of your estate and therefore will be subject to estate taxes.

Converting your Traditional or Rollover IRA doesn't make sense for everyone. We can determine if a conversion will reduce your taxes in retirement and provide another way to leave more money for your heirs.

If you have any questions regarding any of the above, or would like to discuss the contents in more detail, please contact your Wealth Advisor/Relationship Manager or me using the information listed below.

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