Roth IRA conversion overview

An often overlooked strategy when investors are evaluating their retirement and estate planning options is the potential benefit of tax diversification through a Roth IRA conversion. Converting assets to a Roth IRA allows you to lock in today's historically low tax rates and potentially maximize the funds you'll have available to spend in retirement through tax-free distributions.

Why convert to a Roth?

Roth IRAs have some potential advantages over Traditional IRAs. Traditional IRAs allow for tax-deferred growth of retirement assets with taxes being due when distributions are taken. Distributions of Roth IRA earnings are tax-free, as long as you hold the Roth for at least five years <u>and</u> are at least age 59½ or as a result of your death, disability, or using the first-time homebuyer exception. A conversion to a Roth IRA triggers income tax due on the taxable amount converted. So, does it make sense to pay taxes now on your IRA? Here are some reasons why it might.

- Tax diversification potential. Tax-free distributions allow for more flexibility to manage taxable income in retirement.
- No required minimum distributions (RMDs) during your lifetime. RMDs from Traditional IRAs begin at age 70½.
- Generally tax-free distributions for beneficiaries, a feature which supports important estate planning options.
- You are expecting to be in a higher tax bracket in the future. If so, then paying taxes now at a lower rate may be wise.
- You live in a state without state income tax so you will owe less tax on the conversion.
- You have money outside of the IRA to pay the taxes.

Why not convert?

While Roth conversions can provide the potential for favorable tax treatment they are not for everyone. Some considerations to help determine whether a conversion is appropriate for your situation may include:

- A conversion could push you into a higher tax bracket.
- The income generated by the conversion may increase your adjusted gross income (AGI). This could reduce or eliminate certain tax credits or deductions you were eligible for, as well as subject you to a 3.8% Medicare surtax.
- You expect to be in a lower tax bracket in retirement.
- The state you live in now imposes income tax on retirement account distributions and you will reside in a state with lower or no income tax in the future.
- Within the next five years you will need to access the converted Roth funds.
- There are no funds outside of the IRA to pay the taxes on the conversion.
- You will leave your IRA to a charity, or to a beneficiary in a low tax bracket.

What types of accounts can I convert to a Roth IRA?

Most retirement plans are eligible to be converted to a Roth IRA. The table below outlines the plan types and also the Roth conversion options beneficiaries have when inheriting retirement plan assets.

Eligible plans and beneficiary options

Types of plans eligible to convert to a Roth IRA:	**Yes**	**No**
401(k), 403(b), 457(b) plans (a triggering event, such as leaving the company you work for, is required to distribute or convert from plan)	X	
Traditional, SEP & (after 2 years) SIMPLE IRAs	X	
Beneficiary conversion options:		
Spouse inheriting any of the above plans	X	
Non-spouse inheriting 401(k), 403(b) or 457(b)	X	
Non-spouse inheriting a Traditional, SEP, or SIMPLE IRA		X

Greens' hypothetical examples

Hope and Buck Green, age 43 and 45 respectively, are planning to retire in 20 years. They are in the 25% tax bracket and each has a fully taxable $25,000 in a Traditional IRA. Hope feels their tax bracket will increase, so she has decided to convert her Traditional IRA to a Roth IRA paying $6,250 in taxes. We will illustrate three scenarios — one for Buck and two scenarios for Hope showing how she will choose to pay her taxes.

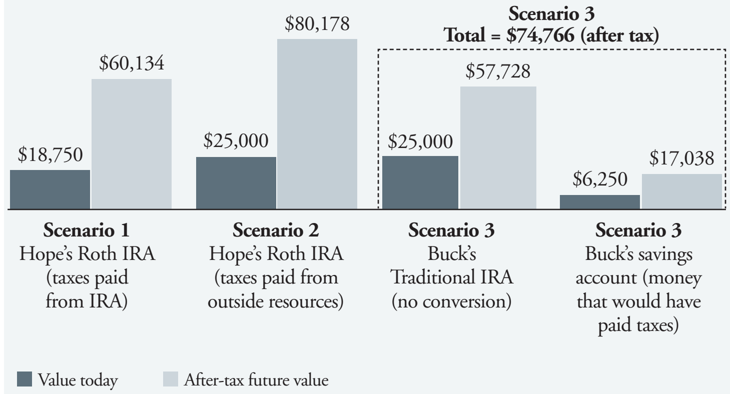
- **Scenario 1** — Hope will pay the taxes due at a 25% tax rate on the $25,000 from her Traditional IRA. This will be an IRA distribution so she will also owe a 10% penalty on the $6,250. This will leave less to convert to the Roth IRA.
- **Scenario 2** — The taxes will be paid from a taxable account and the full $25,000 will be converted to Hope's Roth IRA.
- **Scenario 3** — Buck chooses not to convert. He thinks they could be in a lower tax bracket in retirement, and will invest the $6,250 that he would have used to pay the taxes if he completed a Roth conversion, in a taxable account.

What will the after-tax values of those accounts be like in 20 years? You can see the results in the chart to the right.

- In scenario one, Hope's Roth IRA (where the tax and penalty were paid from the Traditional IRA) has an after-tax value of $60,134 using a 6% rate of return.
- In scenario two where the taxes were paid from a taxable account, the Roth IRA has an after-tax value of $80,178 using a 6% rate of return.
- Scenario three shows Buck's $25,000 Traditional IRA worth $57,728 after he paid taxes at 28%, and his savings of $6,250 was worth $17,038 after paying capital gains taxes at 15%. His two accounts are worth $74,766 after taxes using a 6% rate of return.

As you can see from these hypothetical examples your tax rate, rate of return on your investments, and funds used to pay your taxes have a lot to do with how beneficial a Roth conversion may be to you.

The Greens' hypothetical conversion results



This information is hypothetical and is provided for informational purposes only. It is not intended to represent any specific return, yield, or investment, nor is it indicative of future results.

Talk with us

If you are thinking about a Roth conversion, we suggest you speak with your tax advisor as well as your financial professional. They will be able to review your specific situation and discuss a Roth conversion in more detail.

With you every step of the way

Everyone has a different vision of retirement that requires a unique financial strategy. We can support you in your retirement planning process by providing the guidance needed to make better, informed choices. We will meet with you and help create a comprehensive plan that takes into account your complete financial picture. Your financial professional will be with you every step of the way to monitor your progress and adapt your plan as needed. Working together, we'll design and implement an investment plan that can help you live out your unique vision of retirement.

Traditional IRA distributions are taxed as ordinary income. Qualified Roth IRA distributions are not subject to state and local taxation in most states. Qualified Roth IRA distributions are also federally tax-free provided a Roth account has been open at least five years and the owner has reached age 59½ or meets other requirements. Both may be subject to a 10% federal tax penalty if distributions are taken prior to age 59½.

INVESTMENTS IN STOCKS, BONDS AND MUTUAL FUNDS:

NOT FDIC INSURED	NOT BANK GUARANTEED	MAY LOSE VALUE

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