ROTH IRA CONVERSIONS

Provided by Dominic Lucente

What are your choices? What are the benefits?

If you own an Individual Retirement Account (IRA), perhaps you have heard about Roth IRA conversions. Converting your traditional IRA to a Roth IRA might be a sound financial move depending on your situation.

But remember, this article is for informational purposes only, not a replacement for real-life advice. A professional should be consulted before attempting this type of strategy. Tax rules are constantly changing, and there is no guarantee that the tax treatment of Roth or Traditional IRAs will remain the same as it is now.

Also, Roth conversions have come under much scrutiny during the past few years. Congress has considered legislation that would prevent high-income Americans from Roth conversions. While no action has taken place, it is possible that Roth rules may change in the future.

Why go Roth? Every Roth IRA conversion is based on a belief: the belief that income tax rates will be higher in the future than they are now. If you hold this belief, then you may want to consider a Roth conversion.

Once you are 59½ and have had your Roth IRA open for at least five calendar years, withdrawals of the earnings from your Roth IRA are exempt from federal income taxes. In addition, once five calendar years have passed, you can withdraw your Roth IRA contributions tax-free and penalty-free.[1]

Under current I.R.S. rules, if you are the original owner of a Roth IRA, you never have to make mandatory withdrawals from your account. And you can make contributions to a Roth IRA as long as you continue to have earned imcome.[2]

Currently, if your federal tax filing status is married filing jointly and your adjusted gross income (AGI) is $204,000 or less, you can contribute a maximum of $6,000 to your Roth IRA, $7,000 if you're age 50 or older. The maximum contribution is also available to single filers with an AGI of $129,000 or less. Depending on how high your AGI is, the amount you are able to contribute may change.[3]

Why not go Roth? There are many reasons, but here are two to consider: you have to be prepared for the taxable event and time may not be on your side.

A Roth IRA conversion cannot be undone. The I.R.S. regards it as a payout from a traditional IRA prior to that money entering a Roth IRA, and the payout represents taxable income. That taxable income stemming from the conversion could have tax consequences in the year when the conversion occurs.[4]

In many respects, the earlier in life you convert a regular IRA to a Roth, the better. Your income may rise as you get older; you could finish your career in a higher tax bracket than you were in when you were first employed. Those conditions relate to a key argument for going Roth: it is better to pay taxes on IRA contributions today than on IRA withdrawals tomorrow.

On the other hand, since many retirees have lower income levels than their end salaries, they may retire at a lower tax rate. That is a key argument against Roth conversion.

You could choose to "have it both ways." As no one can reliably predict the future of American taxation, some people contribute to both Roth and traditional IRAs – figuring that they can be at least "half right" regardless of whether taxes increase or decrease.

If you do go Roth, your heirs may receive tax-free distributions. Lastly, Roth IRAs can prove to be very useful estate management tools. If I.R.S. rules are followed, Roth IRA heirs may end up with a tax-free inheritance from the account. In contrast, distributions of inherited assets from a traditional IRA are taxed.1

Under the 2019 SECURE Act, most non-spouse beneficiaries of a Roth IRA are required to have the funds distributed to them by the end of the tenth calendar year following the year of the original owner's death.[5]

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Citations

1 - U.S. News, January 27, 2022
2 - Internal Revenue Service, November 27, 2021
3 - Internal Revenue Service, November 5, 2021
4 - Investopedia, February 2, 2022
5 - Forbes, December 14, 2021