ROTH IRA CONVERSIONS: An upside to market downturns

There may be a silver lining to the current challenging market environment: the possibility of saving money when converting tax-deferred retirement accounts to tax-free Roth IRAs. When asset values are down, moving assets from a traditional retirement account to a Roth IRA can lead to lower taxes on smaller account balances while also shielding future investment gains from taxes as markets recover.

Like any investment decision, Roth IRA conversions have their pros and cons. Before taking action, it is important to understand the potential impact on your income, taxes, retirement plans, legacy goals and other aspects of your financial life.

TAXABLE CONVERSION NOW, TAX-FREE WITHDRAWALS LATER

When converting to a Roth IRA, you pay taxes now in exchange for tax-free retirement income in the future. The process of converting to a Roth IRA involves moving assets from traditional IRAs, 401(k)s, and other accounts that are subject to taxes when withdrawals are taken.

Any pre-tax contributions and investment earnings transferred to the Roth account would be treated and taxed as ordinary income in the year of the conversion. For example, if you convert $50,000 of previously untaxed assets this year, your taxable income would be that much higher on your 2022 federal and state tax returns.

WHY CONSIDER A ROTH IRA CONVERSION?

Anyone with convertible accounts is eligible, regardless of income, age or tax filing status. Reasons to consider the strategy include:

Tax certainty: Lock in current tax rates on known dollar amounts instead of making taxable withdrawals during retirement, when both your account balances and tax bracket may be higher.

Tax-free retirement income: Pay no taxes on your eventual withdrawals as long as the conversions took place at least five years before and you are age 59½ or older.

Eliminate a portion of your required minimum distributions (RMDs): Avoid mandatory annual withdrawals at your required beginning date (currently age 72), as required with tax-deferred accounts, to continue growing assets tax free for later retirement years or for your beneficiaries.

Tax diversification: Gain more control over taxes during retirement by creating the ability to generate income from a variety of sources with different tax treatments.

WHAT SITUATIONS WORK WELL FOR ROTH IRA CONVERSIONS?

Every investor is unique, but they often share similar needs and characteristics that can be addressed with a Roth conversion. Here are six common scenarios:

1. **You are prepared to pay conversion taxes with non-retirement assets.** When converting from a pre-tax account to a Roth IRA, the amount converted will be taxed as ordinary income. Using excess cash or other available assets to pay taxes allows your entire converted account balance to start working on a tax-free basis. Otherwise, you would have to deplete part of your retirement fund to cover the tax bill and may owe an additional 10% penalty if you have not yet turned 59½.

2. **Your income is unusually low this year.** Ideally, you want to do a Roth conversion when your income is down and converted assets will therefore be taxed at lower rates. One example is in your early retirement years after paychecks have stopped but before Social Security benefits and required minimum distributions (RMDs) begin. Other examples include a job loss or pay cut, a spouse temporarily leaving the workforce to raise a family, or business owners experiencing a down year.

   Remember, conversion amounts are added to your income, which can affect more than just taxes. For example, Medicare Part B premiums are based on modified adjusted gross income from two years earlier, meaning conversions completed in 2022 could result in higher Medicare costs in 2024. A general guideline is to convert only enough assets to avoid moving into the next-highest tax bracket or Medicare pricing tier. Your financial advisor can help you navigate these nuances based on your specific situation.

3. **You have offsetting losses to net against the additional income.** Realizing losses in the same year as a Roth conversion may help to offset the additional income and reduce your overall tax liability. There is a $3,000 limit on the amount of capital losses that a taxpayer can deduct against ordinary income in a single year, but additional losses can be carried forward and used in future tax years. Be sure to consult with your financial advisor about your specific situation, because there are differences between the types of losses you may have and how they can be used to offset taxes.

4. **You expect to be in a higher tax bracket during retirement.** Converting tax-deferred assets is most advantageous when future withdrawals from those accounts would likely be taxed at higher rates than they would today. For example, if you expect Congress to raise taxes in the future or if you plan to retire to a high-tax state such as California, it may make sense to convert before then. Keep in mind that even if Congress doesn't act, the current reduced tax brackets instituted by the Tax Cuts and Jobs Act in 2017 are set to expire at the end of 2025.

5. **You want to leave retirement assets to beneficiaries.** If you don't think you will need the money in your retirement account, a Roth conversion would allow you to avoid mandatory withdrawals beginning at age 72 and also help you meet legacy planning goals without complex estate tax issues. Put simply, you can pay income taxes in advance for your beneficiaries, who would inherit the Roth IRA tax-free if it has been converted for at least five years. Spouses can spend down inherited assets over their lifetime, while most others can spread out tax-free distributions over 10 years.

6. **You have a long-term investment horizon.** The longer you wait to tap into Roth IRA assets, the more time you have to recoup conversion taxes and maximize tax-free compounding potential. At a minimum, you must wait five years on each conversion to avoid paying tax on withdrawals of earnings, no matter your age, and a 10% penalty if you are under age 59 ½. Any converted amounts not considered taxable income can be withdrawn at any time without penalty.

DETERMINING A PLAN THAT'S RIGHT FOR YOU

Ultimately, deciding whether a Roth conversion is a good fit for your unique situation depends on your specific goals and circumstances. Will the long-term benefits of a Roth IRA outweigh the upfront tax costs? What else could you do with the assets that would otherwise go toward the taxes you are paying for the conversion? Your BDO wealth advisor can help you make informed choices given your unique situation.

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