Changing Tax Rules Make This Retirement Savings Option Look Even Better

Roth IRA Conversions

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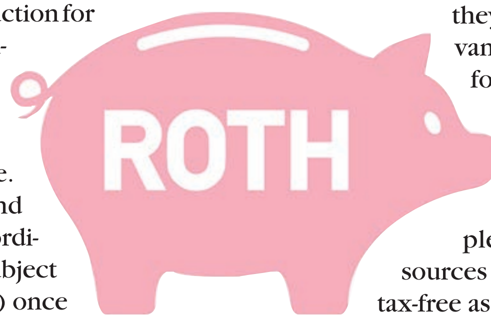
After remaining stable for many years, there have been a number of changes to the rules surrounding individual retirement accounts recently. In our last article, we detailed the changes to the required minimum distribution rules over the past two years. This month we will examine the rules and strategies for converting a traditional IRA to a Roth IRA. While the rules on Roth conversions have not changed (yet), the shifting landscape of IRA regulations has made Roth IRA accounts even more attractive.

Roth IRA Basics

First, some basics. In a traditional IRA, you contribute money to the account and receive a tax deduction for your contribution, subject to certain eligibility limits. If you are eligible to take the deduction, then in its simplest form, a $6,000 IRA contribution will allow you to deduct $6,000 from your taxable income. The money in the IRA grows tax-free and then when you withdraw it, it's taxed at ordinary income rates. Traditional IRAs are subject to required minimum distributions (RMDs) once you reach age 72, as detailed in last month's column.

Roth IRA contributions on the other hand, are made after-tax. There is no tax deduction for the contribution. The money in the account then grows tax-free similar to a traditional IRA, but unlike a traditional IRA qualified withdrawals are not subject to income tax when withdrawn in retirement. Furthermore, Roth IRAs have no required minimum distributions at any age.

Roth IRA contributions are limited to those whose income is below certain income thresholds. For 2022, a full Roth IRA contribution can be made if your taxable income is less than $129,000 for single taxpayers, or $204,000 for those married filing joint. Above those amounts, the amount you can contribute to a Roth IRA is reduced, until it's phased out entirely above $144,000 (single) or $214,000 (joint).



Roth Conversion Rules

Unlike Roth IRA contributions, there are no income limitations on converting an existing IRA to a Roth IRA. If you have an IRA, SEP-IRA or SIMPLE IRA you can convert some or all of the account into a Roth account.

However, the conversion comes at a cost, because it's a taxable event. Unless you have made nondeductible contributions in the past, the entire amount you convert from an IRA to a Roth is taxed at your ordinary income rate. Thus, the first step when considering a Roth conversion is to determine the tax impact.

Generally speaking, tax planning has dictated that it's better to defer paying taxes whenever possible. If you do a Roth conversion you'll be paying more taxes now, which can seem counterintuitive. But, there are situations where paying the tax bill now can result in greater savings down the road.

Benefits of a Roth Conversion

The primary advantage of converting is that when you take qualified Roth IRA withdrawals, they're tax-free. Another big advantage is that you will not be forced to take distributions at age 72 as you must from a traditional IRA.

Converting to a Roth IRA allows retirees who have plenty of income from other sources to let their Roth IRAs grow tax-free as long as they like. In addition, it gives you greater flexibility in retirement, since you have money that can be withdrawn without incurring taxes. This can be particularly helpful for larger purchases like a car or the vacation of a lifetime.

> **"Recent changes to the IRA rules have made Roth IRAs even more attractive for the next generation to inherit."**

Further, if you own a Roth IRA at your death, the distributions your beneficiary will be required to take will be tax-free as long as the Roth IRA has been in existence for at least five years.

In addition, recent changes to the IRA rules have made Roth IRAs even more attractive for the next generation to inherit.

Under new rules enacted in late 2019, anyone who inherits an IRA from someone who is not their spouse must withdraw the entire amount of the IRA within 10 years of the death of the IRA owner. (There are a few exceptions to this rule that we covered in our June 2021 column on beneficiaries.)

Thus, heirs who inherit large or even modest IRA accounts will have a significant tax burden within 10 years, as they draw out the money at ordinary income tax rates. This can be especially onerous for higher earners who don't need the money but are forced to empty the account and pay taxes anyway.

Roth IRAs are subject to this 10-year rule as well, but again all Roth IRA distributions are tax-free. Therefore, the heirs can avoid the heavy tax burden that comes with emptying a retirement account over a shorter period of time.

Disadvantages of a Roth Conversion

Of course, the primary disadvantage of converting to a Roth IRA is the taxes you have to pay upfront. Keep in mind that a taxable conversion not only increases your taxable income, which may push you into a higher tax bracket, but it also increases your adjusted gross income (AGI), which is the basis for many underlying tax calculations.

For example, a higher AGI may cause you to lose some of your personal exemptions and itemized deductions. Social Security benefits are taxed for those with higher levels of income, as are capital gains, and Medicare Part B premiums increase as your AGI rises. The good news is that you can choose how much of your IRA to convert, which allows you some degree of control over the tax impact.

In order to assess the true cost of a Roth conversion, you really need to use income tax software or consult your tax adviser. There are some online calculators but we caution if you use one, be sure you understand the underlying assumptions used to produce the results.

Most Roth conversion analyses focus on a comparison of your tax bracket today and your tax bracket in the future. They point out that if you expect to be in a higher tax bracket in the future, it makes sense to pay taxes now at the lower rate. There is some guesswork involved as to where tax rates will be in the future, but historically speaking today's tax rates are relatively low and may not always remain that way.

Planning Opportunities and Roth Conversions

In general, a Roth conversion makes the most sense if you expect to be in a higher tax bracket in retirement or you don't anticipate needing the money to live on when you retire. This allows you to avoid the required minimum distributions and the taxes associated with them. It also makes sense if you plan to retire to a different state with higher income taxes than your current home state.

A conversion can also be a wealth transfer tool for individuals who want to leave a tax-free retirement asset to children or grandchildren, as they will not be burdened with larger taxable withdrawals upon inheriting the account.

In general, it's not a good idea to convert to a Roth IRA unless you have enough non-IRA money to pay those taxes. If you take money out of your IRA to pay the tax, it'll be harder for the Roth IRA to be worth more to you in the long run. Further, if you're under age 59½ you'll owe a 10% early withdrawal penalty on any amount you withdraw from your IRA to pay the taxes.

When considering a conversion, it's important to have a clear view of your taxable income and tax bracket. Rather than convert your entire IRA, one strategy is to convert enough to "fill up" your current tax bracket.

For example, if a single person has taxable income of $150,000, she is in the 22% tax bracket, which applies to taxable income up to $178,150 in 2022. In this case, she could convert $28,150 from a traditional IRA to a Roth IRA and pay a 22% tax on the conversion. By remaining below the 24% bracket, the overall tax burden of the conversion is lower and the potential for tax savings in the future is greater.

For those who retire before age 72, there can be a "sweet spot" for Roth conversions. Depending on your situation, if you retire at say age 66, you may be in a lower tax bracket for several years, before you reach age 72 and begin taking RMDs. In addition, if you delay taking Social Security until age 70, you may have several years when you can convert a portion of your IRA each year at low tax rates.

Backdoor Roth Contributions

One additional strategy built on Roth conversions may not be available for long. As noted above, for those in higher income levels, annual contributions to Roth IRAs are phased out. But currently there is a loophole in the tax code, nicknamed the "backdoor Roth" that enables anyone to contribute to a Roth IRA each year.

In short, the taxpayer who earns too much to contribute to a Roth directly instead can make a nondeductible contribution to a traditional IRA. The taxpayer can then convert that account to a Roth IRA shortly thereafter. Because she did not deduct the traditional IRA contribution, the entire amount is tax-free, with one major caveat.

If you have an existing traditional IRA account, you can still do this, but you may owe some tax on the conversion. When converting to Roth, the Internal Revenue Service looks at the value of all of your IRA accounts. If you own a traditional IRA account and attempt this strategy, the IRS may consider a portion of the conversion taxable. Thus it works best if your retirement savings are in a company-sponsored plan and you open a separate IRA solely for the purpose of making a backdoor Roth contribution.

This loophole has been debated for years and may finally be closing. If you're phased out of the Roth IRA contribution, you might want to do

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No matter how tempting it is to increase the offer on your dream home during this currently low but rising interest-rate environment, you still want to make sure that you do your homework and research the area you're trying to buy in.

Remember: in real estate, location is king. At the same time, everyone wants to buy their dream home at the perfect price and interest rate…but by waiting for the right moment, you can potentially price yourself out of that perfect home or neighborhood if we continue to see high single or lower double-digit appreciation within the real estate market.

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one last "backdoor Roth" conversion before it's gone.

Conclusion

There is no one-size-fits-all answer to the question of whether a conversion is a good idea. Each individual's circumstances are different and no one knows what the tax rates will be in the future. But certainly the lure of flexibility and tax-free income in retirement makes converting to a Roth IRA worth investigating. We recommend you ask your financial planner and your accountant about whether a conversion makes sense for you.

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