Making Sense of Roth IRA Conversions

Roth IRAs offer the potential for tax-free distributions, which can bring many advantages during the retirement years. There are two ways to contribute to a Roth IRA — through regular discretionary contributions or through a Roth IRA conversion.

Since 2010, legislative changes have made the Roth IRA conversion option accessible to virtually everyone regardless of age, income or filing status. This creates more planning opportunities for those preparing for retirement. A Roth conversion can be an integral part of a successful retirement income plan. Here are some of the benefits of a Roth that may appeal to your retirement-age clients.

Reasons to Consider a Roth Conversion

Long-term tax benefits — Doing a Roth conversion and paying a one-time tax bill on the converted amount provides protection from tax uncertainty and a hedge against future tax increases.

Tax diversification — Spreading out retirement savings between tax-deferred and tax-free accounts brings greater flexibility to the retirement income plan.

No lifetime distributions — Roth IRAs are not subject to the age 70½ mandatory distributions during the account holder's lifetime. Therefore, retirees are not forced to take distributions if they do not need them. This can extend the time of tax-free compounding.

Social Security taxation — Qualified withdrawals from a Roth IRA are not included in the provisional income formula for determining the taxation of Social Security benefits, which can provide more spendable income.

Tax-free legacy — Unlike some tax-deferred vehicles which assign the tax liability at death to the beneficiary, qualified distributions from Roth IRAs pass tax free to the beneficiary. This is useful when coordinating the retirement income plan with the estate plan of the retiree.

Evaluating the Decision to Convert

Once your client has realizes the advantages a Roth conversion can add to their retirement income, it's time to evaluate their specific situation. The amount and timing of a Roth conversion is a significant decision with multiple factors to consider.

To help determine if a Roth conversion is appropriate for your client's specific goals and circumstances, consider the following factors carefully.

Future tax rates — Individuals who believe they will be in a higher effective marginal tax rate in the future should consider converting to a Roth IRA and secure a lower tax rate. Those who expect to be in a lower tax bracket during retirement may be better off not converting and keeping the tax-deferred account as is.

Source of funds to pay the taxes — As a general rule, the benefits of a Roth IRA conversion are optimized when non-retirement assets are used to pay the income taxes following the conversion. Using retirement assets to pay the taxes has drawbacks, will reduce the amount available to accumulate for retirement and would incur a 10% penalty if under age 59½.

Time horizon — Converting to a Roth IRA generally benefits those with longer time horizons, and withdrawals before the completion of the five-year holding period may result in a 10% penalty tax on the converted amounts.

Undervalued assets — The asset value when the conversion occurs determines how much tax will be due. Prime investments to convert are those that have lost value and are expected to appreciate in the future.

Current income tax situation — A Roth conversion may make sense in scenarios where annual taxable income is lower than a typical year, or where tax losses or itemized deductions such as charitable contributions can offset the income tax due to the conversion. Please consult with a professional tax advisor in these situations.

Addressing Effective Marginal Tax Rate

The biggest potential hurdle to overcome with a Roth conversion is the resulting immediate tax liability. This can be addressed as well. New software can help you and your clients identify when and how much to convert without moving up to a higher effective marginal tax rate.

With these tools, you don't have to be an expert to show clients how to avoid this potential tax challenge. Tax Clarity software simplifies the decision making process and helps you advise the most tax-efficient choices for retirement account harvesting. This ultimately helps you position solutions to assist your clients.

Tax Software That Can Demonstrate Your Value

You don't have to be afraid to talk about taxes. Tax Clarity™ software can make the complicated and counter-intuitive tax system more understandable. Revealing to clients how they can make tax-efficient choices in retirement will demonstrate your value and help build trust.

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