Investor Pro-tip

Roth-IRA Conversions

Create tax-free income during retirement

Reading time: 4 min

Roth-IRAs are tax-advantaged retirement savings accounts that may complement your overall investment strategy.

What is a Roth-IRA?

Roth-IRAs are retirement accounts that offer tax-free distributions for retirees. They can be an attractive tool for high-earning households, unfortunately, the US tax code prohibits individuals or households from contributing to a Roth-IRA if they earn over a certain annual income.

Fortunately, there are a couple of workarounds to address these limitations.

Solution 1: **Backdoor Roth Conversion**

Problem: You can't open/fund a Roth IRA because you earn over the income limit – current household limits in 2022:

Modified Adjusted Gross Income (MAGI):

Filing single: Under $144,000

Filing jointly: Under $214,000

Solution: Since *Traditional* IRAs have no income limit, you could open a Traditional IRA and then fund it with a *non-deductible* contribution - meaning you won't claim the deduction on your taxes. You then *convert* the traditional IRA into a Roth IRA.

The Pros: The converted funds now held in the Roth-IRA give you access to your funds - tax free - after age 59.5 with no required minimum distribution. You can even pass it to your heirs (and unlike a Traditional IRA, your heirs owe no taxes on an inherited Roth-IRA). Also, under current regulations, there is no limit to the amount of money you can convert from a tax-deferred account to a Roth-IRA.

The Cons: Because you *haven't yet paid taxes* on the money in a traditional retirement account, when you convert it to a Roth-IRA *the IRS views that as taxable income*. So, you owe taxes on the amount you convert in the year you execute the conversion. For example, suppose you're in the 24% tax bracket and converted $100,000. That means you could owe $24,000 *on top of* your expected annual tax obligation.

Solution 2: Convert Existing Traditional IRA to Roth

Problem: Most of your investment savings are held in traditional, qualified retirement accounts (401(k) or Traditional IRA), with distributions subject to *ordinary income tax rates* instead of the preferential tax treatment afforded to long-term capital gains, preferred dividends, or a Roth-IRA.

Solution: You could consider converting your existing Traditional IRA to a Roth-IRA, paying the taxes in the current year of conversion, and then having a source of tax-free income during retirement. If you believe that your tax rate might be higher in the future or your individual tax situation presents an opportunity now, this may be a good strategy to consider.

The Pros: As with the first solution, the Roth-IRA becomes a source of tax-free income in retirement. Providing greater flexibility to meet your specific income needs and distribution strategy.

The Cons: The taxes must be paid on the amount converted to the Roth in the year of the conversion. Additionally, in 2017 the IRS changed its position on converting back to a Traditional IRA once you have made the switch to a Roth. Now, if you convert your Traditional IRA to a Roth, you can't switch back.

Final Thought

Roth conversions can make a lot of sense for high-earning individuals and households seeking to access tax-advantaged funds in retirement. However, tax implications can be tricky to calculate, so it's important to carefully weigh the potential costs relative to the anticipated future benefits. If you're not sure a Roth conversion is right for you, *give us a call* – we're always available to discuss your options.

Have questions?

Feel free to give us a call and we'd be happy to discuss the pros and cons for your specific financial situation.

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