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New tax optimization series

Is a Roth IRA conversion right for you?

You've probably been socking away extra money in traditional IRAs for years, if not decades. And, if you're like most people, you've probably built up a substantial balance in those tax-deferred holdings. It was the right—*and smart*—thing to do. But as you know, financial situations, tax brackets, *and* tax laws change over the years.

As you approach your retirement, you'll have required minimum distributions (RMDs) that are not only taxable, but they could be quite large, push you unnecessarily into a higher tax bracket, and quite frankly, possibly give you more income than you may need. So what do you do? One way to potentially reduce your tax burden in retirement is to consider converting your traditional IRA to a Roth IRA.

Here's how a Roth IRA conversion works

Your assets are transferred from your traditional IRA to a new Roth IRA reasonably quickly, but the typical holdup is the tax bill due at the time of conversion. Since traditional IRA assets have been tax-deferred, taxes are due at the time of conversion, and a large tax bill isn't something you'll be eager to pay. However, these concerns may be overblown in many instances when you talk to your financial advisor to learn about your break-even tax rate (BETR).

Explore the benefits of a Roth IRA

Roth IRAs have several advantages over their traditional counterpart:

- **No required minimum distribution**—Your advisor can help you on when and how to withdraw funds.
- **Tax-free growth**—All investments in the account grow free from taxation.
- **Tax-free withdrawals**—After age 59½, you can generally tap the account without fear of tax or penalty. Basis can also be withdrawn at any time.
- **Social Security and Medicare flexibility**—Doing a Roth IRA conversion before claiming Social Security and Medicare is beneficial, because future distributions from Roth IRAs won't impact the tax implications of Social Security and Medicare surcharges.
- **Variety of accounts**—Having multiple buckets to withdraw from provides additional tax planning benefits for you.

You may understandably still underestimate the perks that a Roth conversion can provide since you must pay a significant tax bill up front for the transfer. Your advisor can show you when the break-even tax rate (BETR) is considered, and you'll find out how Roth conversions can be more beneficial than conventional wisdom suggests.

Your advisor will use the BETR calculation for more effective planning

The conventional approach is relatively straightforward. Your advisor will calculate your future expected tax rate at the anticipated time of withdrawal and compare it with your current expected tax rate. If current rates are lower, the conversion makes sense. The conventional approach would suggest if current rates are higher, keep the assets in the traditional IRA.

The BETR could be a more effective calculation than simply comparing future and current tax rates. The BETR is the point at which after-tax withdrawal values are the same between converting and not converting, and knowing this break-even point could show that a conversion is beneficial in more instances than relying on the comparison between present and future tax rates alone.

Using the BETR takes more data into the equation, such as:

- Ability to pay conversion taxes from an outside taxable investment account.
- The tax basis of your IRA account. A market pullback is often the best time to make a conversion since reduced capital gains means a lighter tax bill.
- Potential future contributions to the IRA account.
- Your time horizon (a longer time horizon reduces BETR and makes conversions even more attractive).

When paying conversion tax from funds in a taxable account, the BETR approach shows that conversion may be beneficial **even if future tax rates are expected to be lower than current rates.** You'll maximize the assets growing tax-free in the Roth IRA by using taxable funds to pay the conversion tax.

Using the BETR formula demonstrates the usefulness of a Roth conversion. In fact, this approach signals that conversions are often beneficial **even when expected future tax rates are lower** as long as the conversion tax is paid with funds from a taxable account.

A Roth IRA is also terrific account for estate and tax planning purposes, and many investors underestimate the benefits of having multiple retirement accounts to tap. To learn more, discuss a Roth conversion with your financial advisor.

All investing is subject to risk, including the possible loss of the money you invest.

Withdrawals from a Roth IRA are tax free if you are over age 59½ and have held the account for at least five years; withdrawals taken prior to age 59½ or five years may be subject to ordinary income tax or a 10% federal penalty tax, or both. (A separate five-year period applies for each conversion and begins on the first day of the year in which the conversion contribution is made).

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