Should You Do A Roth Conversion?

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A Roth conversion involves moving your assets from a traditional IRA into a (new or existing) Roth IRA[1]. Since the money inside of the traditional IRA is pre-tax, when you convert it to a Roth IRA you must pay the income taxes on it. Then, when you take qualifying withdrawals from the Roth IRA, all of the earnings that have accumulated inside of it are tax-free[2]. In essence, the purpose of a Roth conversion is to (hopefully) pay taxes at a lower rate today instead of a higher rate in the future.

The Math of a Roth Conversion

If you expect to be in a *higher tax bracket* later on, it can be advantageous to (pre-)pay your taxes today by converting the assets held in a non-Roth retirement account into a Roth IRA. However, if you expect to be in a *lower tax bracket* later on, then it makes very little sense to do a Roth conversion since you will be paying taxes at a higher rate today and losing out on all of the tax-deferred growth that you could have earned on those dollars. Finally, if you believe that your *tax bracket will be the same* now vs. in the future (when you intend to withdrawal your money from the Roth IRA), then mathematically there is no difference between doing a Roth conversion or not. So, the question is, how do you expect your marginal tax bracket to change over time?

Other Considerations

1) Tax diversification

Having money in a Roth IRA provides a hedge against the possibility that future tax brackets will be higher than they are today. Think of this as just another way of diversifying your portfolio, except rather than diversifying across asset classes you are instead diversifying the tax status of your money. By paying the taxes on your portfolio now, you get the psychological benefit of "locking in" your tax rate and not having the uncertainty of what your tax rate will be in the future. In contrast, all accumulated earnings in non-Roth IRAs are taxed as ordinary income at the time of withdrawal.

2) Tax bracket management

Having money in a Roth IRA also gives you a tool to manage your overall tax bill in retirement. For example, in a given year you may decide to withdrawal more money from your Roth account rather than non-Roth retirement accounts, thereby keeping you in a lower bracket and reducing your tax bill that year.

3) Roth IRAs make for a better gift to heirs

Beneficiaries of inherited Roth IRAs are not liable for income taxes when they withdraw the funds. If your beneficiaries are in their peak earning years, leaving them a Roth IRA (as opposed to a traditional IRA) can save them from having to pay taxes at a very high rate. Recent changes in the tax code generally require beneficiaries of an inherited Roth IRA to empty the account within 10 years of receipt.

4) Impact on Medicare premiums

The amount you pay in Medicare premiums is based upon your modified adjusted gross income, or MAGI. MAGI includes any withdrawals taken from your traditional IRA. However, it does not include withdrawals taken from a Roth IRA. If you can get money into a Roth IRA prior to going on Medicare, you might find yourself paying lower premiums during retirement. If you are already on Medicare, you have to be careful not to breach certain thresholds of MAGI; otherwise, you (and your spouse if also on Medicare) can be forced to pay a higher Medicare premium the following year.

5) Impact on certain (phased-out) tax deductions and tax credits

Many preferences in the tax code phase out for higher-income taxpayers, meaning their value declines after income reaches a certain level. Examples of this include the Child Tax Credit, Child and Dependent Care Credit, American Opportunity Tax Credit, Lifetime Learning Credit, student loan interest deductions, and the Saver's Credit. If you're not careful, an ill-timed Roth conversion could disqualify you from any number of tax deductions and credits.

6) It takes some work (and calculations!)

As you might have already gathered from the last two points, you need a fairly accurate estimate of what your year-end taxable income and MAGI will be, and a reasonable estimate of whether your future tax rate might rise or fall, when you do a Roth conversion. It doesn't hurt to have a solid grasp of the tax code as well.

Who is a good candidate for a Roth conversion?

Early retirees make ideal candidates for Roth conversions. Typically, early retirees are not yet receiving Social Security retirement benefits and they have after-tax dollars available with which to pay the taxes due on the Roth conversion. Early retirees also often have the ability to do a series of Roth conversions at lower amounts over multiple years so as not to bump up into a very high marginal tax bracket. If you are even younger, you may have other windows of time during which you find yourself in a low-income year and can take advantage of a Roth conversion—e.g., taking a sabbatical or a mini-retirement from work, starting a new company with minimal revenue, or going to graduate school.

The Bottom Line

A Roth conversion can be a great financial planning strategy that gives you added flexibility to manage your taxable income in retirement, helps you further diversify your portfolio, and can lower your lifetime taxes. The key point with a Roth conversion is that your tax bracket today is lower than what you expect it to be in the future.

1) Roth conversions can be done from a traditional IRA, rollover IRA, or workplace retirement plans like a 401(k)
2) For qualifying withdrawals, generally you must be at least age 59.5 and have held the Roth IRA for 5 years from the time of conversion. There are other exceptions outside of the scope of this article.

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