CONSIDERATIONS FOR ROTH IRA CONVERSIONS

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ABSTRACT

This paper describes many factors that should be considered by those who are contemplating an IRA to Roth IRA conversion. While these conversions can be very helpful to some taxpayers, certain qualifications must be met, and individuals should be sure they understand the ramifications before they convert amounts to Roth IRAs.

Keywords: Roth IRAs, Roth Conversions, Retirement Accounts, Taxes on Retirement Savings

INTRODUCTION

Historically, traditional advice was to plan for retirement by deferring tax on retirement savings as long as possible. This was accomplished by using IRAs, 401(k) accounts, and other similar accounts to shield contributions from current taxes, deferring the taxation on both the contributions and the earnings until the funds are withdrawn during retirement. However, in recent years, retirement planning advisors may now advise using Roth IRAs, at least to some extent, to eliminate future taxes even though it means paying taxes currently on contributions to those accounts.

Some reasons for this change in direction include (1) the expectation of rises in future tax rates, perhaps significant rises, because of the deficit federal government spending which is unsustainable, (2) the likelihood that many who plan well may have more income during retirement than they had while working, thus putting them in a higher tax bracket during retirement, and (3) the desire to have some sources of retirement income that will not be taxed to allow for maximum flexibility as to what retirement accounts to draw from during retirement to manage lower taxes from year to year.

Individuals who have exclusively used tax-deferred retirement accounts or who have significant assets in tax-deferred accounts may consider IRA to Roth IRA conversions. These conversions allow certain individuals who have tax deferred-tax retirement savings to shift some of those savings to Roth IRA accounts to avoid future taxes. As would be expected, amounts converted from an IRA to a Roth IRA become taxable in the year of the conversion, but the amount transferred and the future growth in the Roth IRA account will not be taxed when withdrawn later during retirement.

While some individuals may be greatly benefitted by converting tax-deferred retirement savings to a Roth IRA, not everyone will qualify, and those who do qualify and are considering such a conversion need to be aware of possible consequences of doing so. A Roth IRA conversion should be considered only as part of an overall retirement plan rather than being considered as a distinct and separate decision. Otherwise, a Roth IRA conversion could potentially end up with costs exceeding benefits.

ROTH INDIVIDUAL RETIREMENT ACCOUNT BASICS

Contributions to Roth IRAs in a given year, like regular IRAs, are limited by the amount of earned income. Individual annual contribution limits also exist—$6,000 per person in 2022 (indexed over time), increased by $1,000 (not indexed) for those over age 50. If a married individual has a spouse with minimal income, that individual can also fund the annual limit to the spouse's Roth IRA if the individual's earned income is large enough to fund both accounts. The ability to contribute also phases out over a range of income, also indexed over time. For 2022, the phase-out range is $204,000 - $214,000 for those married filing jointly or $129,000 - $144,000 for those who file as single, head of household, or married filing single (as long as they did not live with the spouse during the year), so not everyone qualifies to make contributions directly to a Roth IRA (IRC, Sec. 408A; How Roth IRA Taxes Work).

As the contributions to a Roth IRA have already been taxed, there are no required distributions during the account holder's lifetime as there are with a regular IRA. The account can continue to grow indefinitely, both from contributions (as long as they are supported by earned income) and earnings during the owner's lifetime. However, when the account holder dies, there are now specific rules for distributions, depending on who the beneficiary is. While important, these specific rules are not relevant to the focus of this paper.

Because the contributions to a Roth IRA have already been taxed, they can be withdrawn at any time without taxes or penalties. However, if earnings in a Roth IRA are withdrawn without meeting certain conditions, they may be subject to both taxes and/or penalties. If the account owner is over age 59½ and the account (or the account holder's first Roth IRA account) has been open for at least five years, there are no taxes or penalties on the withdrawal of earnings. However, even though the account holder is at least 59½, if that individual does not have a Roth account that has been open for at least five years, the withdrawal of earnings will be subject to taxes (but not penalties) (How Roth IRA Taxes Work).

If a Roth IRA account holder is under 59½ and make withdrawals of earnings, those withdrawals may be subject to taxes and penalties. The taxes and penalties can be avoided in certain situations if the account has been open for at least five years. Even if the account has not been open for at least five years, the penalties, but not the taxes, can be avoided in specific situations (How Roth IRA Taxes Work). Again, the exceptions are not discussed, as they are not the focus of this paper.

From this information, it may be wise for anyone (1) who qualifies to open a Roth IRA, (2) who does not have one, and (3) who may ever want to have one, to open a Roth IRA now so the five-year ownership period can be running. This is true even if only a modest amount is currently invested in the account. In fact, it might be a good idea for parents who have children who start working and generating earned income to help their children open a Roth IRA account, even if the parents provide the initial funding on behalf of the children.

FACTORS TO CONSIDER

Direct contributions to Roth IRAs have annual dollar limits and income limits as set out above. However, an IRA to Roth IRA conversion is a "backdoor" approach to funding a Roth IRA without dealing with those limits, so a Roth IRA conversion may be desirable for those who do not qualify for direct contributions or those who want additional amounts directed to their Roth IRA. Several factors to consider before making a Roth conversion are discussed in this paper. Other factors not included here may also relate to one's personal situation.

Existence of IRA

Before individuals can convert amounts from an IRA to a Roth IRA, they must first have an IRA to convert. This could be a previously funded IRA for someone who has made individual contributions to an IRA over time. It is also possible that someone who has an employer-sponsored, tax-deferred retirement account may be able to roll some money from that account to an IRA, which could later be converted to a Roth IRA. However, if someone under age 59½ is still working for that employer, the plan may not allow a rollover. Once the employee reaches age 59½, there may be more flexibility for a rollover, especially with money contributed to the plan by the employee. If an individual leaves an employer to take a new job, there again may be more flexibility to roll money from a previous employer's plan to an IRA. And after someone retires and is at least age 59½, there is even more ability to roll retirement account balances into an IRA. Of course, if an individual has no IRA and no accounts that can be rolled into an IRA, at least currently, then a Roth IRA conversion is not possible. For example, someone who has been working for an entire career for an employer who has a generous defined benefit pension plan may not have tax deferred accounts that are either IRAs or can be converted to IRAs. These plans will provide deferred compensation to the individual during retirement, but this deferred income, while it will be taxed as received, is not likely available to the individual in a form that can become an IRA. Thus, it would not be convertible to a Roth IRA.

Current Marginal Tax Rates versus Future (Unknown) Marginal Tax Rates

Individuals should consider the potential impact of the Roth conversion on their marginal tax rate for the year of conversion. The additional taxable income from the conversion, depending on the amount converted, could push them into a higher tax bracket.

If individuals anticipate enough taxable retirement income to keep them in a tax bracket at or above their current tax bracket (or a rise in future tax rates to keep them in a higher tax bracket regardless of income), then Roth IRA conversions may make sense. They may allow someone to pay taxes now at a similar or lower rate compared to what would be paid later but then shield the earnings in the Roth IRA from any future taxes. If someone still has many years before accessing that money, the tax-free appreciation in the account may easily make up for paying the taxes earlier, even when considering the time value of money.

On the other hand, as an individual converts a larger proportion of retirement income to a Roth IRA, the remaining taxable retirement income may leave that individual in a very low tax bracket later, perhaps negating the benefit of having paid taxes at a higher rate earlier. So, even for someone for whom a Roth IRA conversion makes sense, there may be an optimal amount or proportion of retirement savings to convert to maximize the tax benefit over time adjusted for the time value of money. It likely does not make sense to plan to be in a 0% tax bracket for a portion of one's retirement years if that benefit comes by paying taxes in earlier years at high rates. Because these decisions are made in an environment of uncertainty, no plan will necessarily be perfect.

Marital status, both now and in the future, will also affect both income levels, tax brackets, and limits on certain tax items. Marital status, employment status, and income levels all interact when considering marginal tax rates now and in the future.

Employment Status, Income Level, and Age

Someone who is still working and earning income will be in a different situation from one who has retired. Obviously, if one is still working and earning income, additional income from a Roth IRA conversion will be considered differently than for one who is no longer working. An individual's tax bracket may already be higher if the individual is still employed, and the income from the Roth IRA conversion may affect the marginal tax rate differently for one who already has more earned income.

Whether or not an individual (and the individual's spouse) are receiving Social Security payments can also affect taxable income and the resulting marginal tax rate. Depending on one's income level, up to 85% of Social Security benefits may be included in taxable income, again potentially affecting the marginal tax rate, especially in conjunction with any Roth IRA conversion (see Income Taxes and Your Social Security Benefit).

In addition, there are other taxes/costs that may need to be considered before making a Roth IRA conversion. One is the net investment income tax (NIIT). This is an additional 3.8% tax on investment income for those who have adjusted gross income in excess of $250,000 (for those married filing jointly or filing as a surviving spouse; $125,000 for those married filing separately, $200,000 for other filers). If a Roth IRA conversion will cause this limit to be exceeded, the amount of additional NIIT tax owed should also be considered an additional cost of making the conversion (IRC, Sec. 1411).

A second cost that should be considered is the cost for Medicare insurance premiums paid for oneself and/or a spouse for those who are on Medicare (or will be within two years). Medicare Part B premiums are based on adjusted gross income two years prior to the year the premiums will be paid. For example, premiums for 2022 are dependent on adjusted gross income for 2020. For a married couple filing jointly, the monthly Medicare premium for 2022 is $170.10 for each insured individual if the adjusted gross income (AGI) is $182,000 or less ($91,000 or less for those filing individual tax returns). However, the individual monthly premium goes up to $238.10, $340.20, $442.30, $544.30, or $578.30, as AGI levels continue to increase. Thus, for anyone who is on Medicare or who will be within two years (including a spouse), the effect of a Roth conversion on Medicare insurance premiums should also be considered. Although this is not a specific increase in the current tax rate, it is a cost that should be factored into the conversion decision (2022 Medicare Costs).

For someone enrolled in Medicare Part D, those premiums are also based on income level. While the amounts are much less than the Part B premiums, a similar increase in premium exists for those in higher income brackets (2022 Medicare Costs).

Another potential issue to consider, at least in the future, deals with limitations on itemized deductions. Up through 2017, the benefit of itemizing deductions was phased out for certain high-income levels, depending on filing status. The Tax Cuts and Jobs Act of 2017 (TCJA, 2017) eliminated this phaseout, at least for the years 2018-2025. However, the TCJA also increased the standard deduction substantially and put a $10,000 limit on state and local taxes that can be itemized, so fewer individuals are currently claiming itemized deductions on their tax returns. For 2015-2017, the percent of individual income tax returns claiming the standard deduction hovered around 68-69 percent; for 2018 and 2019, the percent increased to over 87 percent (calculated from data in IRS, 2019, Table A). If a similar itemized deduction phaseout is reinstated when many of the provisions of the TCJA sunset after 2025, the cost of lost itemized deductions may be yet an additional cost of a Roth IRA conversion if the converted amount takes an individual's AGI into or over the phaseout range.

Current age is also a factor. Obviously, the sooner someone makes Roth conversions, the longer the money can grow in the Roth IRA, thus shielding more earnings from taxes permanently. However, those who are younger and raising families may find it more difficult to pay the taxes currently on amounts converted, as they may have tight budgets for current budgeted expenditures. These individuals may prefer to use a tax-deferred retirement savings plan until their income increases over time and they have more discretionary income, perhaps after children are raised, college costs are covered, and a house paid for.

Ability to Pay Taxes on Converted Amount

Because a Roth IRA conversion will require the payment of taxes on the amount converted in the current year, anyone planning for a conversion should anticipate how the taxes will be paid on the converted amount. Will the additional taxes be paid with other money outside of retirement accounts? Will the additional taxes be paid with money coming from a retirement account (for those who are old enough to withdraw from retirement accounts either with or without penalties)? Is it worth withdrawing additional amounts from tax-deferred retirement accounts to pay the taxes if this money will no longer provide tax deferral or be available for retirement?

Charitable Desires During Retirement

If part of a retirement plan includes making significant charitable contributions, someone with an IRA may want to be careful not to convert too much of it to a Roth IRA. The reason for this is the existence of a tax law allowing a qualified charitable distribution (QCD) by an individual who is at least 70½. A QCD is a direct IRA to charity transfer that is (1) never included in income, (2) counts as part or all of the annual required minimum distribution (RMD) from the IRA (for those over 72 who have RMDs), and (3) provides a tax advantage to the donor without the need to itemize deductions. An individual can transfer up to $100,000 per year through a QCD if qualifications are met (IRC, Sec. 408(d)(8)). Smith and Smith (2017) provide more details about the qualifications for a QCD. Even though the age for RMDs has risen to 72, the age for QCDs is still 70½.

Other Considerations

Because a Roth IRA conversion is a "backdoor" approach to funding a Roth IRA for those whose income is too high to directly fund a Roth IRA (or for those who want to put more into their Roth IRAs than they can based on the annual contribution limit), there may be pressure on politicians to eliminate this tax provision. However, it does generate current tax revenues, as those who use it will otherwise continue to postpone payment of taxes if their money stays in a tax-deferred account. So, the generation of current tax revenues may be a counteracting argument to eliminating Roth IRA conversions. However, since it is possible that a Roth IRA conversion could either be eliminated or reduced, those who are interested in a conversion may want to do so sooner to avoid the possibility that this tax strategy could be eliminated.

Another reason for considering a Roth IRA conversion sooner is that tax rates were reduced temporarily by the Tax Cuts and Jobs Act (TCJA) in 2017. At this time, the reduced rates are in effect for 2018 through 2025. So, conversions during that time frame, can be taxed at lower tax rates than those that existed before and those we might anticipate later, even without considering the need for tax rate increases due to the increased and increasing national debt.

If retirement savings are invested in a fluctuating market, it is understood that the market will go up and down. Sometimes market corrections cause larger market losses, which are generally reversed over time. While it may be dangerous to try to time the market with purchases and sales of investments as a general rule, a market downturn (if expected to be temporary) might be a good time for a Roth IRA conversion. Transfer the money from the IRA when the market is down, put it into the Roth IRA, and then let the appreciation of the market recovery occur in the Roth account. This way the taxes will only be paid on the depressed value of the amounts transferred, thus reducing both the amount of taxes and potentially the marginal tax bracket for those taxes. However, assuming similar investments are made in the Roth IRA, the recovery should be just as good in the Roth IRA as it would have been in the IRA, but the increase in the account when the market recovers would never be taxed.

Depending on the timing and the amount of a Roth conversion, an individual may need to pay estimated taxes, either through quarterly estimated tax payments starting for the quarter of the conversion or through increased tax withholdings through an employer for someone still employed. If tax prepayments through withholdings and quarterly estimated tax payments are not adequate, the individual could become subject to tax penalties for underpayments.

As evidenced by the many factors discussed here, an individual contemplating a Roth IRA conversion should understand his/her personal situation and the ramifications of making such a conversion. It may be helpful to consult a professional, but understanding one's own situation and knowing the effects of specific decisions related to a conversion will also be helpful, as the individual will bear the consequences of decisions made, positive or negative.

CONCLUSION

This paper has described an IRA to Roth IRA conversion and has presented many factors that should be considered before making such a conversion. A Roth IRA conversion may be beneficial to many taxpayers who qualify to make one. However, multiple factors must be considered to "optimize" the results of such conversions. In addition to the factors discussed here, there may be other specific factors that should be considered for individual circumstances. Also, since these conversions are still made in an environment of uncertainty, especially uncertainty about future tax rates and laws, there is no guarantee that current decisions will end up being optimal. However, many taxpayers may be better off by considering at least some amount to convert to avoid paying taxes on future appreciation of retirement investments.

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