MARINER

EARLY RETIREMENT

Should You Consider a Roth Conversion?

You may know that there are several good reasons to consider converting your traditional IRA to a Roth IRA from both a tax-planning and an estate-planning standpoint. But when is the best time to do a Roth conversion? For many people, the answer is early in retirement.

Paying Taxes to Be Free of Taxes

Roth conversions involve selling part or all of one's assets in a traditional IRA, which is funded with pretax dollars. The process includes paying the required ordinary income tax and then reinvesting the net proceeds into a Roth IRA. Assets in a Roth grow and are withdrawn tax free. Required minimum distributions (RMDs), which apply to traditional IRAs starting at age 73 (or 75 depending on your birthdate), don't apply to Roths.

The Timing Question

A key consideration in Roth conversions is minimizing the income tax liability that results from liquidating part or all of your traditional IRA. Many people assume that once they're retired, their income will drop and they'll wind up in a lower tax bracket. But RMDs from retirement accounts, Social Security payments and other income sources, such as a pension, could keep you in a high tax bracket. The goal is to smooth out your tax liability over your lifetime. That's what can make the strategy of converting early in retirement attractive.

The Early Retirement Sweet Spot

Recently retired individuals often find themselves in lower tax brackets than they were during their working years and possibly lower than they will be in the future—sometimes called a tax desert. These are the years after retirement, prior to RMDs. That's because work income has stopped, Social Security income hasn't yet kicked in and RMDs are still in the future. These early retirees can also steer toward lower tax brackets by limiting distributions from retirement accounts. And doing a Roth conversion while in a lower tax bracket means a greater net distribution that can be rolled over into the new account. What's more, converting to a Roth early in retirement can still provide ample time for tax-free growth.

Benefits Over Time

It's important to understand that the income tax bill triggered by a Roth conversion can be considerable and will likely need to be paid either from savings or from the proceeds of the conversion. But the fact that RMDs are not required for Roths may mean years or even decades of tax-free growth and withdrawals—and that may help you come out ahead over time. Your wealth advisor can calculate whether a Roth conversion, either partial or full, might work to your advantage over the long term.

Tax Management Strategies

A number of strategies are available to help manage the tax liability of a Roth conversion. If you plan to make charitable gifts, the related tax deductions can be used to offset Roth conversion taxes while fulfilling your philanthropic goals. It can be especially effective to condense multiple planned gifts into a single, large contribution in the year you complete your IRA conversion, thereby enlarging your deduction and providing a timely tax break. Donor-advised funds (DAFs) can be a helpful tool here: Contributing to a DAF results in an immediate tax deduction and gives you the freedom to choose how and when your gift will be distributed to qualified charities.

Leaving Tax-Free Assets to Heirs

Roth IRAs can also be advantageous from an estate planning perspective. The non-spousal beneficiary of an IRA is legally required to distribute the entire account within 10 years after inheriting it. Many heirs are in their peak earning years at the time of inheritance, meaning they're already in a high tax bracket. Having to take taxable distributions from a traditional IRA means their tax liability, and possibly their tax bracket, will rise. On the other hand, distributions from inherited Roth IRAs are not taxable.

Each Situation Is Unique

The decision about whether and when to do a Roth conversion includes many variables, and there's no rule of thumb that works for everyone. Depending on your situation, the tax math may or may not work to your advantage. Roth conversions might also be less attractive for those without heirs. Again, your wealth advisor can model out various scenarios to help you make your decision.

The Bottom Line

Roth IRA conversions can be an effective way to reduce future tax liability, provide tax-free growth, eliminate or reduce RMDs and enhance estate planning flexibility. While they can be done at any time, early retirement is indeed the sweet spot for many people because income, and tax brackets, may be lower, making the strategy more cost effective. Consult your wealth advisor to discuss whether a Roth conversion early in retirement makes sense for you.

Roth IRA Conversions are complex, and treatment depends on the type of IRA converted to a Roth IRA. The views expressed regarding Roth Conversions are for commentary purposes only and do not consider an individual's personal, financial, or tax considerations. Before initiating a Roth IRA Conversion, please consult with a financial or tax professional and ensure you consider all your available options, including applicable taxes, fees, and features. Suppose you convert a Traditional IRA to a Roth IRA. In that case, the conversion amount will be treated as a distribution for income tax purposes and is included in your gross income (excluding any nondeductible contributions). Although the conversion amount generally is included in income, the 10% early distribution penalty tax will not apply to these conversions, regardless of whether you qualify for any exceptions to the 10% early distribution penalty tax. If you are required to take a required minimum distribution (RMD) for the year, you must remove your RMD before converting to a Roth IRA.

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