The Power of the Roth Conversion

How to Keep More of What's Yours

FORAN FINANCIAL GROUP

Introduction

Minimizing taxes is an important part of a successful retirement plan. The less money you spend on taxes, the more you'll have to live the retirement you've dreamt of. But keeping taxes low can be a challenge when most of your retirement savings have been accumulated in pre-tax accounts like your 401(k) or Traditional IRA.

One way to help you keep taxes low in retirement is by having multiple sources of income you can withdraw from, including after-tax sources like a Roth IRA. This would allow you to avoid needing to withdraw too much from pre-tax sources that could generate hefty tax bills. The challenge, however, is that the IRS has income limits on who can make Roth IRA contributions. If your Modified Adjusted Gross Income (MAGI) is over a certain threshold, you can't contribute to a Roth IRA – unless you use a Roth rollover.

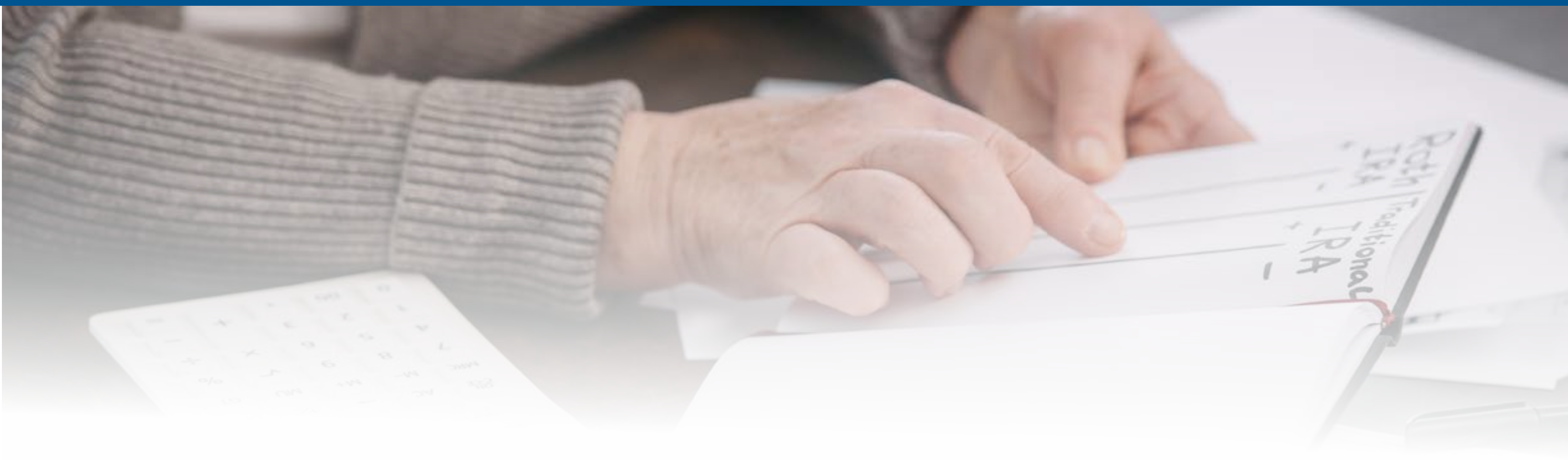
A Roth rollover, or conversion, is a workaround that allows you to take advantage of a Roth IRA, and its many tax benefits, regardless of your income. While this can be an excellent strategy for your retirement planning, it's not right for everyone. And once a Roth conversion is done, it can't be undone!

Before you attempt a Roth conversion on your own, make sure to educate yourself on the pros and cons.

We created this eBook to guide you through the Roth conversion process and help you decide if it's the right move for you.

For more information, schedule a no-obligation consultation with the Foran Financial team. Our financial advisors are specialized in this area and would love to meet with you to review your options.

Contact us today.



What is a Roth Conversion?

A Roth IRA rollover, also called a Roth conversion, transfers money from a pre-tax retirement account, such as a Traditional IRA or 401(k), to a Roth IRA. You pay taxes on the money you convert in the year of the rollover, but then get to keep the money in the Roth IRA where it can grow tax-free.

Since Roth IRAs are not subject to Required Minimum Distributions (RMDs) and Roth distributions aren't taxable, Roth conversions can help minimize taxes in retirement. They can be particularly advantageous for people who have large Traditional IRA or retirement account balances and don't want to end up with large tax bills in retirement. Likewise, if you expect to be in a higher tax bracket in later years, you can use a Roth conversion to pay the taxes on your pre-tax savings now.

How Do Roth Conversions Work?

Roth conversions are a fairly simple process. You start by funding your traditional retirement account, either a Traditional IRA or a 401(k). Since these accounts are funded with pre-tax dollars, you'll get to take a tax deduction for the amount you contribute. But since Roth IRAs are after-tax accounts, you'll need to pay taxes on the money when you roll it into your Roth IRA. Depending on how much you rollover and if you've already taken the deduction for your traditional contributions, this could result in a substantial tax bill for the year.

Any amount you rollover from a Traditional IRA or 401(k) to a Roth IRA must be included as income on your New Jersey state tax return the year you withdraw them from the Traditional IRA.

The easiest way to do a Roth conversion is as a direct rollover from one IRA account to the other. Simply tell your financial advisor that you'd like to transfer the money from your Traditional IRA directly to a Roth IRA either at the same provider or another institution. If you don't already have a Roth IRA, you'll open one during the conversion process.

You could also do an indirect transfer using the 60-day rollover method. In this case, you'd receive a check distribution from the Traditional IRA and have 60 days to deposit it into your Roth IRA.

Converting assets from a 401(k) or another employer-sponsored plan can be a little more complicated. You generally need to wait until you leave your employer to access the money in your employer-sponsored plan, although some employers allow "in-service distributions."

You'll need to contact your employer-sponsored plan directly to begin the Roth conversion. Let them know you'd like to rollover the assets directly to the financial institution where your Roth IRA is held.

If your employer plan sends you a check, it will withhold 20 percent of the balance to cover the taxes of a distribution. You'll then have 60 days to put the money, plus the 20 percent that was withheld, into your Roth IRA. If you miss this deadline, you may owe a 10 percent early withdrawal penalty if you're under 59-½ years of age.

Once the conversion is complete, you generally need to leave the assets in the Roth IRA for five years to avoid any penalties and taxes. After the five-year requirement has been met, distributions from a Roth IRA are tax- and penalty-free provided you are at least 59-½ years of age. If you're younger than this, you can still access your contributions tax- and penalty-free after the five years have elapsed, but any earnings you withdraw will be taxed and penalized.

Note that you must take your RMD before doing a Roth conversion. You also cannot convert a RMD into a Roth.

The IRS generally limits you to one rollover every 12 months. You also cannot make a rollover from the receiving IRA during this period.

HOW DOES THIS ALL BREAK DOWN? HERE'S AN EXAMPLE

The real advantage of a Roth conversion lies in the power of compounding. To illustrate this with a numerical example, consider "Linda."

Linda* has a $700,000 Traditional IRA and is in the 22 percent federal tax bracket and 5.525 percent New Jersey state income tax bracket with $50,000 of annual income.

About to begin her RMDs, Linda decides to convert $25,000 of her IRA each year, which would keep her still within the same federal and state tax brackets. After paying taxes on her conversion, she gets to put about $18,000 into her Roth IRA. If she does this each year for 15 years and earns an annual rate of return of 7 percent, she would have more than $545,000 in her Roth IRA 15 years from now. This is money she can now withdraw at any time tax-free, or leave for her heirs to inherit.

Doing so also allowed her to reduce her RMDs during that time period by more than $136,000.

The example above was created using the following sources:

- *Federal tax brackets: https://www.google.com/search?q=2021+tax+brackets&rlz=1C1CHBF_enUS940US940&oq=2021+tax+brackets&aqs=chrome..69i57j0i20i263j0l8.4168j0j4&sourceid=chrome&ie=UTF-8*
- *NJ State tax brackets: https://www.incometaxpro.net/tax-rates/new-jersey.htm*
- *Compound interest on $18,000 contributed annually for 15 years: https://www.bankrate.com/calculators/savings/compound-savings-calculator-tool.aspx*
- *RMD calculations: https://www.irs.gov/pub/irs-tege/uniform_rmd_wksht.pdf*

Why You Would Do a Roth Conversion

Roth conversions can provide many benefits, including:

- **TAX-FREE WITHDRAWALS:** After the five-year rule has been satisfied, you can withdraw money from your Roth IRA without owing taxes. This makes Roth IRAs potent, long-term saving vehicles as your earnings grow tax-free. Traditional retirement account distributions, on the other hand, are taxed at ordinary income rates.

- **WITHDRAWS AT ANY TIME:** Since you've already paid taxes on your Roth contributions, you can access them at any time after the five-year aging rule has been satisfied. That said, the longer you leave the money in the account, the more it can benefit from that tax-free growth. Also note that if you withdraw your investment earnings before age 59-½, you'll owe ordinary income taxes plus a 10 percent penalty on that amount.

- **NO RMDS:** Roth IRAs are also exempt from RMDs. This makes the tax-free growth within a Roth even more advantageous, as you can leave the money in the account beyond your RMD age.

- **ESTATE PLANNING TOOLS:** Since you are not required to withdraw money from a Roth IRA, they can be powerful estate planning tools. Your beneficiaries will have to take RMDs, but they can do so without paying federal income taxes on their withdrawals after the five-year rule has been met.

- **A WORK-AROUND FOR INCOME RESTRICTIONS:** A Roth conversion lets you access all of the above benefits of a Roth IRA even if you earn above the IRS's Roth IRA contribution income limits. By first putting the money into a Traditional IRA, which has no income restrictions, then moving it into your Roth IRA, you can use this backdoor approach to funding a Roth.

Disadvantages to a Roth Conversion

Given the many advantages to a Roth conversion, you may wonder why someone wouldn't want to do one. But there are drawbacks to the strategy as well.

The main disadvantage to a Roth conversion is the cost. You will have to pay taxes on any amount you convert. If you make a significant rollover or are in a high-income tax bracket at the time of the conversion, this could result in a hefty tax bill. If you convert a significant amount, you also run the risk of getting bumped into a higher tax bracket, which would raise your bill even more.

Some people choose to use part of the converted balance to pay the tax bill, much like when you withdraw from your 401(k), they withhold 20 percent of the amount you request. This strategy means you'll have less money invested in the Roth to benefit from the tax-free growth. It's also not recommended if you do the conversion before turning 59-½, because this may trigger the 10 percent early withdrawal penalty on top of the taxes you'll already owe.

Another disadvantage to Roth conversions is the five-year rule. You have to wait at least five years to withdraw converted money from a Roth IRA to avoid taxes and a potential penalty. So, if you think you'll need the money sooner than your conversion's five-year birthday, you may not want to put it into a new Roth.

Why You Wouldn't Want to Make a Roth Conversion

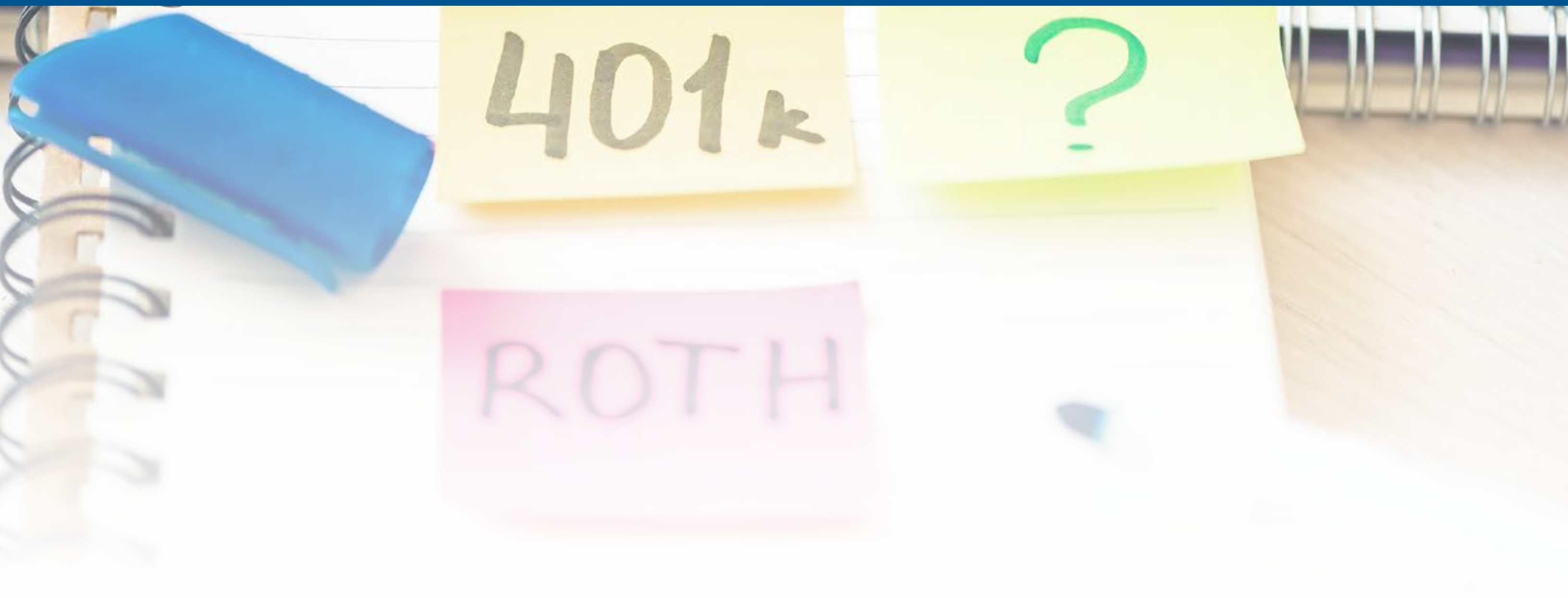
Roth conversions are not for everyone. Here are some of the instances when you wouldn't make a Roth conversion:

- **YOU'LL BE IN A LOWER TAX BRACKET IN RETIREMENT:** The point of a Roth conversion is often to minimize taxes, so it doesn't make much sense to do a conversion if you think you'll be in a lower tax bracket later on. New Jersey is not considered a tax-friendly state, so if you plan to relocate from New Jersey when you retire to a lower tax state, such as Florida or Virginia, for example, you may do better to postpone your conversion until then.

- **YOU CAN'T PAY THE CONVERSION TAXES:** Roth conversions will raise your tax bill the year you make the conversion. If you don't have the funds to pay that bill now, you should probably avoid the conversion. As discussed above, using a portion of the rollover to pay your tax bill only counteracts the tax saving benefits of the rollover.

- **THE ROLLOVER WILL RAISE YOUR TAX BRACKET:** Since Roth conversions are included as income on your New Jersey and federal tax return, they can bump you into a higher marginal tax bracket. If this is an issue, you may want to spread your conversion out over multiple years.

- **YOU'LL NEED THE MONEY IN LESS THAN FIVE YEARS:** If you think you'll need to use the money you're planning to convert in less than five years, there's likely no reason to convert it as you'll end up paying taxes anyway.



Should You Make a Roth Conversion?

Ultimately, Roth conversions are personal decisions. Since everyone's situation is different, the decision of whether to make a conversion or not needs to be made on a case-by-case basis.

If you're still unsure if a Roth conversion is right for you, consult a financial advisor. At Foran Financial Group, we can evaluate the potential tax impacts of a Roth conversion, both this year and in the future. If the numbers don't line up this year, there's always next year.

About Foran Financial Group

For more than a combined 60 years, Somerville, New Jersey-based Foran Financial Group has been helping families build sustainable wealth. We offer personalized, intensive financial planning and full-service wealth management in a personal, supportive environment. Our multi-generational planning and investment team has helped hundreds of families pursue greater financial confidence.

Contact us today, and get the conversation started!

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance referenced is historical and is no guarantee of future results. A Roth IRA offers tax deferral on any earnings in the account. Qualified withdrawals of earnings from the account are tax-free. Withdrawals of earnings prior to age 59-½ or prior to the account being opened for five years, whichever is later, may result in a 10 percent IRS penalty tax. Limitations and restrictions may apply. Traditional IRA account owners have considerations to make before performing a Roth IRA conversion. These primarily include income tax consequences on the converted amount in the year of conversion, withdrawal limitations from a Roth IRA, and income limitations for future contributions to a Roth IRA. In addition, if you are required to take a Required Minimum Distribution (RMD) in the year you convert, you must do so before converting to a Roth IRA. This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.