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COMMENTARY

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Roth IRAs and Roth Conversions

The prospect of tax-free income during retirement is appealing to many investors. It can be incredibly advantageous to have multiple "buckets" of income to pull from throughout retirement. Having this flexibility allows investors or their advisor to take advantage of the wide array of market conditions that may be present in retirement years.

The Roth IRA was established by the Taxpayer Relief Act of 1997. Rather than deferring taxes on contributions into an account and paying the tax upon distribution in retirement, Roth contributions are funded with after-tax dollars with no immediate tax benefit. The primary advantage of Roth IRAs is that all qualified distributions are tax free.

However, with such a large benefit comes a few restrictions, such as:

- Contributions in 2024 are capped at $7,000 per year with an additional $1,000 per year "catch-up" contribution for those 50 and older.
- High income earners are phased out of contributing. The phase-out range for married taxpayers filing jointly is $230,000–$240,000. For single taxpayers and heads of household the phase-out is $146,000–$161,000.
- You must be age 59 ½ or older and have had the account for at least 5 years to withdraw funds without an earnings penalty (other exceptions apply). If an investor hasn't met the five-year holding requirement, earnings can be subject to taxes but not penalties.
- There are no required minimum distributions (RMD) on Roth IRA accounts.
- Roth IRA accounts left to heirs is also non-taxable.

Many investors can feel left out of the benefits of a Roth IRA for various reasons. They may have income that exceeds the limits, contributed to a 401k during the course of their employment and rolled it into a traditional IRA rollover, or the Roth IRA wasn't available to them during their time of employment.

Fortunately, the Internal Revenue Service allows for Roth IRA conversions. Individuals can move money from a traditional IRA or 401k to a Roth IRA regardless of income. This will allow the individual to convert their pre-tax dollars into tax free distributions in the future. However, there is a catch. In the year the individual converts the funds, they must pay tax on the total amount converted and the conversion itself can push someone into a higher tax bracket.

Following are some additional considerations we believe you should review:

- Will your tax bracket be the same or higher moving forward? If yes, a Roth conversion can make sense.
- Conversion dollars cannot be accessed for 5 years. Any conversion starts a 5-year clock. The converted dollars cannot be withdrawn without a 10% penalty for 5 years. All conversions restart this time period.
- Having a Roth to pull from in retirement may lower your tax bracket in the future.
- Roth funds do not count in the calculation for taxing Social Security benefits.
- Although market declines are an unavoidable part of the investment process, down markets can present tax planning opportunities. When a traditional IRA has temporarily lost value, it is possible for the investor to convert a larger portion of that IRA while paying the same amount of taxes. This now allows the greater amount of assets moved into the Roth IRA to recover within a tax-free account. In such a case, the investor has now moved future growth into a tax-free bucket.

For example, assume an investor plans to convert $150,000 of a $1 million-dollar account. This equates to 15% of the account. A decline in markets has resulted in a 10% loss within the account bringing it to $900,000. This allows the investor to still convert $150,000, but it now equates to approximately 17% of the account value. The investor has now converted a greater share of their account while still paying the same amount in taxes. This greater percentage of the account is now able to grow tax-free in their Roth giving them greater income flexibility in future years.

Generally speaking, Roth conversions will create a tax liability that needs to be funded. The two most common ways to fund this liability are cash on hand or using monies from the converted funds. Utilization of cash on hand, when possible, is far and away the preferred strategy.

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Doing this allows 100% of the funds to remain invested and grow tax-free. Then, when taking future distributions, the money that would have gone to pay taxes has appreciated in value and is fully available to the investor.

Saving for retirement in any capacity is a win. We recommend that investors analyze and utilize tools to save as much and as efficiently as possible is a major advantage when working with a financial advisor, as well as legal and tax professionals. Ultimately, creating a tax-efficient retirement income strategy can help investors attain a desired lifestyle during retirement that includes peace of mind. Utilizing a Roth IRA and analyzing the benefits of a Roth conversion during a down market can be useful tools for attaining an investor's retirement income goals.

For other Karpus insights, please see our website.

Source: CNBC, Congress.gov, Fidelity, Kiplinger, Schwab, The U.S. Internal Revenue Service, Schwab

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