

Why consider a Roth conversion

You may be wondering if a Roth IRA conversion makes sense for you to consider. The information in this fact sheet provided by Robert S. Keebler, CPA, M.S.T., a partner with Keebler and Associates, may help address questions you may have.¹

Six reasons to consider a conversion

In his study and analysis, Keebler found six reasons why someone may consider converting to a Roth IRA:

1. To take advantage of favorable tax attributes
2. Suspension of the lifetime required minimum distribution (RMD) rules
3. The payment of income tax prior to the imposition of estate tax allows for greater wealth to be transferred to future generations
4. Greater growth potential, to the extent that outside sources (i.e., taxable brokerage accounts) are used to pay for the taxes due on the Roth conversion
5. To effectively reduce the taxable estate of the IRA owner
6. To hedge against the projected increase in tax rates when a spouse dies

Keebler discovered that generally, the following key factors need to be identified and addressed in order to best analyze a Roth IRA conversion:

1. Retirement account balance
2. Time horizon
3. Current and future cash flow needs
4. Current marginal tax rate versus projected future marginal tax rate
5. Ability to pay the income tax with non-retirement funds
6. Estate planning objectives

Four types of conversion

Keebler also discusses four types of Roth IRA conversions that may need to be considered. The strategies discussed may not be appropriate for your personal situation. As with all strategies of this type, while your financial advisor at Wells Fargo Advisors is eager to work with you with respect to retirement planning, the advice of your tax and legal advisor will be important in your decision on whether or not you should convert to a Roth IRA.

Strategic conversions

In a strategic conversion, the Roth IRA is viewed as a wealth transfer tool, not a retirement income vehicle. After conversion, the Roth IRA owner is not subject to RMDs, so the full balance of the account is able to compound tax-free. Most non-spouse beneficiaries will have to empty the Inherited Roth IRA by the 10th year following the year of the IRA owner's death. No distributions are required before the 10th year. Generally, the distributions will be income tax-free². By not taking any distributions from the Inherited Roth IRA until the 10th year, your beneficiary can have potential earnings growing tax-free. This may make the Roth an excellent option to transfer wealth to heirs.

Strategic conversions should be considered and special heed paid to:

- Tax rate difference between current and anticipated future income tax brackets
- Ability to use non-retirement funds to pay income taxes due
- Time horizon with the realization that the longer a Roth can grow prior to any distributions the better

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Tactical conversions

In a tactical conversion, the Roth is used as a tool to realize short-term, unused special tax attributes, such as:

- Net Operating Loss (NOL) carry forwards
- Business and other ordinary losses
- Charitable contributions carry forwards
- Non-refundable tax credits

With this method, you complete the conversion to generate taxable income. This then helps you realize a favorable tax attribute and may result in virtually little or no income tax on the Roth conversion.

Opportunistic conversions

An opportunistic conversion might allow you to take advantage of short-term economic conditions that are expected to reverse over time. An example may be an IRA portfolio that has lost value due to market conditions, but is expected to rebound in the future. An investment that is expected to have rapid growth in the near future is another example.

Hedging conversions

Finally, a conversion may be considered to hedge against some future event that might result in higher taxes. These may include both income tax and/or estate tax. In situations where a couple, currently filing a joint tax return, experiences a health decline in one spouse that may result in death, the surviving spouse could be quickly forced into a single tax filing status. If the survivor's income doesn't decrease after the other's death, he or she could pay significantly more in taxes as a single filer. Converting to a Roth IRA in a year where the tax filing status remains joint could result in fewer tax dollars being due.

Keep in mind

You should understand your tax situation and your ability to pay for the conversion. Because, once you convert, you can no longer recharacterize, or undo the conversion. Also, an IRA conversion or rollover conversion from an employer sponsored retirement plan to a Roth IRA cannot be recharacterized.

Conclusion

Roth conversion planning is quite complex. We are pleased to offer this information and look forward to working with you and your tax advisor in evaluating your unique situation.

With you every step of the way

Everyone has a different vision of retirement that requires a unique financial strategy. Wells Fargo Advisors can support you in your retirement planning process by providing the guidance needed to make informed choices. We will meet with you and help create a comprehensive plan that takes into account your complete financial picture. Your financial advisor will be with you every step of the way to meet to review your progress and adapt your plan as needed. Working together, we'll design and implement an investment plan that can help you live out your unique vision of retirement.

1. Keebler and Associates is not affiliated with Wells Fargo Advisors. This article is sourced for informational/education purposes only.

2. Qualified Roth IRA distributions are not subject to state and local taxation in most states. Qualified Roth IRA distributions are also federally tax-free provided a Roth IRA has been open for at least five years and the owner has reached age 59½ or meets other requirements. Roth IRA distributions may be subject to an IRS 10% additional tax if taken prior to age 59½.

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