Roth IRAs – Could You Benefit from a Conversion?

By Kimberly Sterling

Roth conversion questions are bubbling up with the concern that personal tax rates will be higher in the future. While we can't predict when taxes may go up, they are certainly the lowest they've been in many years. So, it's natural to wonder: What circumstances might make a Roth conversion beneficial?

We've been learning, analyzing, and thinking about Roth conversions since 1997 when they were first created. Last year's SECURE Act took away a significant Roth benefit: heirs must now distribute all inherited Roth balances within ten years. Previously, Roth accounts could be distributed over the lifetime of heirs!

The allure of Roth accounts is that all future growth and earnings (along with the amount converted) are 100% exempt from taxation when withdrawn. The longer the Roth investments have to grow, the greater the potential tax-free benefit. An investment earning 8% would double around every 9 years: so, a $50k Roth conversion could grow to $100k in 9 years, $200k in 18 years, and $400k in 27 years.

Sounds great, but paying tax today on a Roth conversion is a known cost. Without a clear expectation of a future benefit and/or enough time to let the Roth grow, you are voluntarily paying more tax to the government. And, you won't get a thank you note!

There is one clear opportunity that is a known winner for Roth conversions – being in a low or zero tax bracket. Here are some situations we've seen:

- Individuals who retire early or before age 70 could have low-income years. They no longer have a salary, don't have to start social security (until age 70), or take minimum retirement distributions (until age 72).
- During retirement, individuals might have large medical expenses that reduce income to the 12% bracket or may even generate negative income. This commonly happens when someone moves into a retirement community, and a significant portion of their large entrance fee is designated as a medical expense.
- Taxpayers who own their own companies might have large business losses that reduce income to the 12% bracket or generate negative income.
- Taxpayers with low income might make a significant charitable contribution in one year that results in low income.

These taxpayers have control over how much of their IRA to convert to a Roth. They can decide to take advantage of all negative income and perhaps pay tax up to the top of the 12% bracket. To be beneficial, they should expect that their tax rate will be 12% or higher in future years.

The result for these known winners is zero to 12% tax now on the Roth conversion, and zero tax in the future when the Roth funds are withdrawn. Either the taxpayer or their heirs will get a benefit from the future untaxed Roth value.

Another, perhaps more common opportunity, is young taxpayers (think teens to 30s). As long as their taxable income is less than $124k (single) or $196k (married), they can make a Roth contribution. However, the best benefit comes from young earners with income below $40k (single) or $80k (married) who are in the 12% bracket or less. Young workers have the added advantage of letting this money grow 30 years or more until they retire so they maximize the Roth benefit. The only expectation required for them to attain this benefit is that their tax rate will be higher than 12% in future years. They could also decide not to spend a dime of their Roth during their lifetime and leave it to their children, who would be required to withdraw it within ten years of the parent's death.

There may be one other Roth opportunity, but it is an outlier. A taxpayer in their 30s or 40s with ultra-wealth might generate a benefit for their heirs by converting money to a Roth at today's rates and letting it grow 40 to 50 years until their children inherit it. Two factors are at work to make this successful: one is a lower tax cost now than the heirs will be in upon inheritance and second that the Roth earns 8% or more for at least 40 years.

Many may be tempted to make a Roth conversion because they have a strong belief that tax rates will go up at some point. That is a rational expectation. But, rates for capital gains and regular taxes would almost have to double within the next 30 years to pay today's top rate of 37% for a Roth conversion and come out ahead. Paying taxes now is like digging a very deep hole. The hole gets filled in slowly over time with investment growth and no tax on the earnings. It takes about 30 years just to fill up the hole. Then it takes another 10 to 20 years to add some real value to the Roth.

Keep in mind too that changes in the tax law can wipe out future anticipated benefits. As mentioned in the beginning of this article, last year's SECURE Act was a *huge* blow to heirs and their parents who may have paid dearly to create Roth accounts. Did you know that Social Security used to be 100% excluded from taxation for everyone? There's no guarantee that Roth IRAs will always be untaxed. If money is needed, the government will find a way to increase revenue and the individuals with means and resources are always a prime target.

If you think you're a candidate for conversion, talk to your RCG advisor. We will help you assess that opportunity.

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