Roth IRA Conversion: To Convert or Not to Convert?

Most of us are familiar with Traditional IRAs and Roth IRAs, but the great debate has been on the wisdom of converting a Traditional IRA to a Roth IRA.

Traditional IRAs were authorized in 1974 and intended to allow individuals who did not have an employer-sponsored pension plan to save for retirement on a pre-tax basis. The contributions and investment growth would be taxed when distributions were made. Traditional IRAs also allow for contributions on an after-tax basis but that is less common. It is, however, fairly common for workers who leave their place of employment to rollover account balances from employer-sponsored retirement plans, such as a 401(k) plan, to a Traditional IRA.

Over two decades later, Roth IRAs were authorized to allow for after-tax contributions. However, the contributions and investment growth would be tax-free when qualified distributions were made. These features have made Roth IRAs extremely popular and attractive for tax and retirement planning purposes especially because many believe income tax rates will go up in the future.

Since Roth IRAs came into being, the question of whether to convert or not to convert a Traditional IRA to a Roth IRA has been a hot topic. While tax-free growth and distributions are extremely attractive, one of the main consequences of a conversion is the income tax liability created by the conversion of pre-tax contributions and growth of a Traditional IRA to tax-free growth and distributions of a Roth IRA. Among the many other considerations to account for when determining the desirability to convert are the following ten. This list is not all-inclusive.

1. **Sufficient Assets and Cashflow:** First and foremost, consider whether you have the assets and cashflow to make the conversion. A Roth conversion is not free. There are income tax consequences to the conversion so anyone considering it must have the resources such that the income tax liability will not adversely impact the ability to meet other lifestyle expenses.

2. **Tax Cuts and Jobs Act of 2017 (TCJA):** The TCJA impacted many aspects of personal income tax planning. A few of the changes included reducing the individual tax rates and shifting the income thresholds within the tax brackets; doubling the standard deduction; eliminating the phase-out of itemized deductions ("Pease limitations"); and more. All of these changes, however, will sunset by December 31, 2025. In other words, in 2026, we go back to the way things were prior to the TCJA, including higher income tax rates, unless further legislation is passed.

3. **Employment Lifecycle:** Younger workers tend to be starting out in their careers and not yet in their peak earning years. As a result, they may be in a lower income tax bracket. Conversely, retirees may be in a lower tax bracket than during their working years. A Roth conversion is always better when you're in a lower tax bracket because of the income tax impact of the conversion.

0015524XX 07/2022

4. **Income Fluctuation:** If your income lessens in a particular year due to unforeseen circumstances like a layoff, or because you have the ability to control your income through qualified and nonqualified deferred compensation plans, that year of temporary lower income may be an opportune time to consider a Roth conversion because you may be in a lower income tax bracket.

5. **Equity Markets:** If your qualified plan and IRA account balances have been adversely impacted by market volatility, a stock market correction, or a recession, but you are a long-term investor and retain a positive outlook for the future, then that may be an opportune time to do a Roth conversion. Lower account balances in your IRA will result in lower income tax consequences.

6. **Social Security and Medicare:** If you are already receiving Social Security benefits and/or Medicare, a Roth conversion may result in higher income for the year of conversion. In turn, that impacts the taxation of your Social Security benefits and may also increase your Medicare costs. Therefore, a Roth conversion may not be appropriate.

7. **Investments Outside of Retirement Plans:** When a Roth conversion is implemented, income taxes would generally be owed. Taxes should typically be paid from other sources such as bank accounts or other taxable accounts. Using the proceeds from the conversion to pay the immediate income tax burden may negate the future tax benefits of the conversion.

8. **Charitable Contributions:** If you are over the age of 70 ½ years, charitably inclined, and make regular and significant donations, you may be better off making those contributions straight from your Traditional IRA through a Qualified Charitable Distribution (QCD), rather than doing a Roth conversion and making charitable contributions through other assets. A QCD does not increase taxable income for the year but counts toward required minimum distributions ("RMDs") from the IRA starting at age 72.

9. **RMDs:** Traditional IRAs have RMD requirements starting at age 72. Calculating RMDs are somewhat complicated and the failure to take a RMD may result in significant penalties. Roth IRAs do not have RMD requirements. So, if you're fortunate enough to not have to rely upon your Traditional IRA for retirement, then a Roth conversion may make sense for you.

10. **State of Residence:** When you do a Roth conversion, not only will you owe Federal income taxes but depending upon where you live, you may also owe State and local income taxes so that must also be accounted for.

Conclusion

While Roth IRAs are very attractive because of tax-free growth and tax-free qualified distributions, converting a Traditional IRA to a Roth IRA is not for everybody. There are many factors to consider when deciding if the conversion is right for you. While we have listed several considerations, there may be many more based upon your unique situation.

For More Information Contact:

To determine if this strategy makes sense for you, contact your Security Mutual Life insurance advisor today to get the process started. Your advisor will coordinate with your tax professional to review your situation and to determine the plan and strategies that are appropriate for you and your family.

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