Taxation - Income, Estate, and Gift

The Roth IRA conversion decision.

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Traditional Individual Retirement Accounts (IRAs) and Roth IRAs provide tax breaks in different ways. Contributions to traditional IRAs are generally tax deductible, and growth is tax deferred, but withdrawals are taxable as ordinary income.[1] By contrast, contributions to a Roth IRA are not tax deductible, but growth and qualified withdrawals are tax free.[2]

The Roth IRA Conversion Decision

There will often be an economic advantage in converting a traditional IRA to a Roth IRA, but not in all cases. In deciding whether to do a Roth IRA conversion, taxpayers must analyze the tradeoff between paying current tax on the amount transferred and avoiding tax on later distributions from the account. The analysis begins with a comparison of the taxpayer's marginal income tax rate at the time of the conversion to the taxpayer's expected marginal income tax rate when distributions are received. Note the following general rules.

- If the tax rate is lower at the time of conversion than at the time distributions are received, a Roth conversion will be favorable.
- If the tax rate is substantially higher at the time of conversion than the rate when distributions are received, a Roth conversion will be unfavorable.
- If traditional IRA assets are used to pay the conversion tax and the tax rate is the same at the time of conversion as at the time of distributions, converting will be neutral.
- If "outside assets" can be used to pay the conversion tax, a Roth conversion will be favorable even when the tax rate at the time of conversion is slightly higher than at the time distributions are received. The extent to which this is true depends on the difference between the pre-tax rate of return in the IRA and the after-tax rate of return of the outside assets.

These rules are illustrated in the following, somewhat simplified, examples. (All the examples assume that IRA assets are used to pay the conversion tax.)

Example 1: Art, a married taxpayer filing jointly, has $50,000 in a traditional IRA. Assume that the $50,000 will double in value by the time Art retires and that he takes a lump sum distribution at that time. Assume further that Art is currently in the 24% marginal income tax bracket. The chart on the following page compares the net after-tax wealth realized from converting with not converting, assuming his marginal tax rate:

- Drops to 22%,
- Stays the same, or
- Increases to 32%.

Paying the Conversion Tax with Outside Funds

As noted above, paying the conversion tax with outside funds significantly

1 It is possible to make a non-deductible contribution to a Traditional IRA as well, and such amounts may generally be withdrawn free of income tax, subject to certain ordering rules.

2 To be a qualified withdrawal from a Roth IRA, a distribution must generally be made after the later of: (1) when a taxpayer reaches age 59½, or (2) the end of the five tax-year period beginning with the year of the first contribution.

The Roth IRA Conversion Decision (Example 1)

	Marginal income tax rate drops to 22%		Marginal income tax rate remains 24%		Marginal income tax rate increases to 32%	
	Convert	Don't convert	Convert	Don't convert	Convert	Don't convert
Beginning value	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000
Current tax	$12,000	0	$12,000	0	$12,000	0
Amount remaining	$38,000	$50,000	$38,000	$50,000	$38,000	$50,000
Value at retirement	$76,000	$100,000	$76,000	$100,000	$76,000	$100,000
Tax payable	0	$22,000	0	$24,000	0	$32,000
Net amount	$76,000	$78,000	$76,000	$76,000	$76,000	$68,000

improves the economic result of a Roth conversion. This might make a Roth conversion favorable even if the tax rate is higher at the time of conversion than it is when distributions are received.

Example 2. Beth is a single taxpayer with a 30% combined federal and state income tax bracket in 2018. She has $50,000 in a traditional IRA and $15,000 of liquid assets in a side fund, which are available to pay the taxes from a Roth IRA conversion if Beth chooses to do one. Assume that the assets in the IRA will quadruple in value by the time Beth retires in 25 years, but the side fund will only triple in value because it is subject to tax. At the end of the 25-year period, Beth will receive a distribution of the full amount in the IRA and will be in a 25% combined federal and state tax bracket. The chart below compares the net amount realized for the Roth IRA conversion decision.

Under these facts, a Roth IRA conversion results in $5,000 more of

Paying the Conversion Tax with Outside Funds (Example 2)

	No conversion Leave assets in Traditional IRA.	Roth IRA conversion Use side fund to pay conversion tax.
Beginning balance	$50,000	$50,000
Conversion tax	0	$15,000
Value of IRA after conversion tax	$50,000	$50,000
Value after 25 years	(4 x $50,000)= $200,000	(4 x $50,000)= $200,000
Tax on distribution	$(50,000)	0
Amount after distribution tax	$150,000	$200,000
Plus value of side fund	(3 x $15,000) = $45,000	(eliminated to pay conversion tax) 0
Total net after-tax wealth	$195,000	$200,000

after-tax wealth than not converting, even though the tax rate drops from 30% to 25%. In effect, the taxpayer is able to pack more value into the IRA by paying the conversion tax with outside funds, which grow faster inside the IRA than they would if they remained in the taxable side fund.

Other Factors Favoring a Roth IRA Conversion

Even if a Roth IRA conversion doesn't produce greater net wealth in the basic calculation as illustrated above, there may be other important advantages to a Roth:

- Can make contributions after age 70½ (if the taxpayer has earnings in the year of the contribution, §408A(c)(4)).
- No required minimum distributions (RMDs) starting at age 70½.
- Tax-free income in retirement (Adjusted Gross Income is therefore lower, which offers income tax benefits elsewhere).
- Facilitates wealth accumulation for heirs if the account owner doesn't need the money in the Roth IRA.
- Tax-free withdrawals for beneficiaries after the death of the IRA owner.
- Hedge against possible future increases in income tax rates.

Note that taxpayers with favorable tax attributes such as charitable deduction carry-forwards, investment tax credits or expiring net operating losses, may be able to efficiently utilize these attributes to reduce the effective tax rate on a Roth conversion.

The decision to effect a Roth conversion is complex and depends on a careful analysis of numerous factors. With the help of astute advisors, however, many individuals with traditional IRAs may stand to benefit significantly from considering such a strategy.

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