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Is a Roth Conversion Right for You?

Moving assets to a Roth IRA can provide more income flexibility in retirement.

KEY POINTS

- A Roth conversion could be especially beneficial if you expect to be in a higher tax bracket in retirement.
- With a Roth conversion, taxes are due on the converted amount in the year of the transaction.
- There are different conversion methods that may help you cover these costs.

There is a fairly simple financial move that can create significant advantages for many investors: converting a Traditional individual retirement account (IRA) to a Roth IRA. While it may not be the right choice for everyone, Roth conversions can provide tax diversification and help many investors increase their future financial flexibility in retirement. Every investor may want to consider gaining some exposure

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to Roth IRAs. For retirees, having a Roth IRA can increase their after-tax income, since qualified withdrawals from the account are income tax-free and may be made at the discretion of the investor.*

Why convert?

There are a number of benefits to owning a Roth IRA. The trade-off is that moving assets from a Traditional IRA to a Roth IRA generally requires paying taxes at the time of the account conversion rather than later, when you start taking withdrawals.

Deciding whether to convert assets to a Roth IRA depends largely on what you anticipate your future income tax bracket will be. The conversion could be especially beneficial if you expect to be in a higher tax bracket in retirement—you'll pay the taxes now at your lower current rate. That said, the move may be advantageous if you think your tax rate will stay the same and even in some cases if you expect it to decline. Having tax-free Roth assets can provide you with freedom to use that money to pay for expenses in retirement, such as a new roof or a special vacation, without increasing your annual taxable income. Conversely, if you used money from your Traditional IRA to pay for those expenses, those assets would be included in your taxable income and potentially could increase your marginal tax rate as well as your Medicare premiums.

Additionally, Roth IRAs do not have required minimum distributions (RMDs), which make them a valuable retirement and estate planning tool. If you don't need to make withdrawals during retirement, you can leave those assets—and any tax-free earnings they generate—to your heirs. The amount you pass on to heirs can continue to grow tax-deferred in their Inherited Roth IRAs. Your heirs will be required to take RMDs each year, and they can always withdraw more whenever they need it. Leaving a Roth IRA to a beneficiary is one way to generate potentially tax-free income for your loved one.

The cost of conversion

Before converting, consider each of the following strategies for paying the taxes.

- Stagger the conversion. If a Roth IRA conversion would push you into a higher federal tax bracket, consider conducting multiple partial conversions over a period of a few years.
- Generally speaking, it's ideal to pay taxes on the conversion from a taxable account. This method may have the smallest tax consequences.
- If you don't have enough savings in a taxable account to pay the taxes, consider taking a tax-free withdrawal from an existing Roth IRA. Note that for those under age 59½, only contributions can be taken tax-free. Generally, if you're age 59½ or older and have held the account for at least five years, however, you can take tax-free withdrawals of both contributions and earnings.
- If neither a taxable account nor an existing Roth IRA is available to pay the taxes, you can consider withdrawing from a Traditional IRA. One consequence is that this would result in additional taxes on the amount you withdraw to pay the conversion taxes. And if you tap in to the Traditional IRA when you're younger than age 59½, your withdrawal will be subject to a 10% early withdrawal penalty.

Converting at least some of the assets in your Traditional IRA into a Roth IRA may provide you with considerable flexibility in retirement. As with anything, there are pros and cons to converting your money. After weighing your options, you'll be positioned to make the choice that's best for your personal circumstances.

*A qualified distribution is tax-free if taken at least five years after the year of your first Roth contribution and you've reached age 59½, become totally disabled, died, or met the requirements for a first-time home purchase.

A Comparison of IRAs

Both Traditional IRAs and Roth IRAs offer unique tax advantages.

With a Traditional IRA, you have to start taking required minimum distributions (RMDs) from the account each year once you reach age 70½. Since this withdrawal amount generally is treated as ordinary income, you may be obligated to pay taxes on withdrawals. With a Roth IRA, there are no RMDs, and you can make qualified withdrawals without paying taxes.

	Traditional IRA	Roth IRA
Taxes on withdrawals	Withdrawals of pretax contributions and earnings are taxed as ordinary income	Generally, withdrawals of contributions and converted assets are tax-free. Withdrawals of investment earnings are also income tax-free if: ▪ you've held the account for at least five years, and ▪ you are age 59½ or older
Required minimum distributions (RMDs)	Must take your first RMD by April 1 of the year after the year you turn age 70½	None
Early withdrawal penalties	Withdrawals of contributions and earnings prior to age 59½ may be subject to a 10% penalty (with some exceptions)	Withdrawals of earnings that are not qualified distributions may be subject to a 10% penalty (with some exceptions). Withdrawals of converted assets may be subject to a 10% penalty (with some exceptions) before the converted account is five years old
Advantages[1]	▪ Tax-deferred potential growth ▪ Tax-deductible contributions (when applicable)	▪ Tax-deferred potential growth ▪ Tax-free qualified withdrawals ▪ No RMDs ▪ Heirs can take potentially tax-free withdrawals from Inherited Roth IRAs
Considerations	▪ Withdrawals of pretax contributions and earnings are taxed as ordinary income ▪ RMDs begin at age 70½	▪ Contributions are not tax-deductible ▪ Heirs must take RMDs
Spousal beneficiaries[2]	Subject to RMD rules	No RMDs
Non-spousal beneficiaries	Non-spousal beneficiaries can take distributions from an Inherited IRA before age 59½ without incurring the 10% early withdrawal penalty. They also can designate their own beneficiaries for the Inherited IRA. ■	

[1]Subject to phase-out based on IRA owner's modified adjusted gross income for deductibility to a Traditional IRA or for contributions to a Roth IRA.

[2]If spouse elects to treat the Inherited IRA as his/her own.

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