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IRA

Conversion

ROTH

Roth IRA Conversions – Everyone's Favorite Tax Topic

Hi everyone, thanks for reading today! Today I want to talk to you about the nuances of Traditional IRAs and Roth IRAs and how you can understand and take advantage of some strategies here. But before we do so, let's just go over the basics of these:

Basics of IRAs (Traditional vs Roth)
With these accounts – you can contribute up to $6K per year if you are under 50 and $7K per year if you are over 50. If you are over certain income thresholds you can't contribute to a Roth IRA, or also a Traditional IRA (if you have an employer sponsored retirement plan). If you don't have an employer sponsored retirement plan, you can freely contribute and deduct Traditional IRA contributions.

Traditional IRAs are funded with pre-tax dollars, and you get a tax deduction each year that gives you up front tax savings. i.e., If you contribute $6K to this, that is deducting $6K of income from your tax return that year. The money grows tax-deferred while it is in the account, and when you take it out it is subject to ordinary income tax rates. At age 59.5 you can take it out without any penalty (if you take it out prior to 59.5 you are subject to a 10% penalty) and at age 72 you are required to start taking Required Minimum Distributions (RMDs). When you pass away your heirs also have to take RMD's subject to their own ordinary income tax rates.

Roth IRAs are funded with after-tax dollars so there are no upfront tax savings, but the savings are on the back end because you pay no tax on any future withdrawal – the growth is all tax-free. However, you still have to wait until 59.5 to access the growth portion of the money or you will be hit with a 10% penalty, unless you take out for qualified reasons, or you take out your basis without penalty. When you pass away, your heirs will also not be taxed on these accounts.

One caveat is necessary here – you need earned income to contribute to these accounts. If you are retired and don't have earned income, you most likely can't contribute. If you are filing Married Filing Jointly on your taxes and only one spouse has an income, that is fine and both of you can still contribute. However, you can only contribute up to the limit of your income. (i.e., If you only make $4K of income per year, you can't contribute $6K to an IRA or Roth IRA.

Traditional 401k and Roth 401k
These are work sponsored plans with the same tax properties as noted above but have no income limitations! Also, if you are under 50 you can contribute up to $19,500 in these or up to $26K per year if you are over 50!

Roth conversions
If you want to get more than $6K per year into a Roth, you can move money from an IRA to a Roth – which is called a Roth conversion and you can do any dollar amount. However, when you do this, you need to pay ordinary income tax on the amount that you do (i.e. if you do $20K conversion, you would add $20K to your ordinary income for that year).

It may make sense to do this if your business has a tough year, or if you are starting a new business and your income may be lower than otherwise it will be, you can do this at a lower tax bracket and try to convert up to the 12% or 22% tax bracket, understanding your tax bracket may be higher in the near future.

It also may make sense to do this for Individuals who retire prior to 72 (i.e. Retiring at 62 or 65 or 70) and you are not required to take

RMDs yet, have no earned income coming anymore, and you can live off of after-tax accounts (savings account, taxable account, etc.) your income may be lower and you can convert to Roth's to maximize up to 12 or 22% bracket again, and get money working tax free and not take RMDs from those balances in the future!

Another option may be to do this if there is a pull-back in the market. (i.e., If the market is temporarily down in value, and your IRA value went from $100K to $70K, and you convert it then you are only paying tax on $70K instead of $100K).

The concept boils back to triggering income today intentionally and paying tax on a lower tax bracket than a higher tax bracket you may be in the future.

One other caveat is necessary to consider here, is that once you convert, it cannot be undone. So, it may make sense to wait until December to do these things, so you have all relevant tax and income information understood and realized before doing it.

'Backdoor' Roth IRAs

If you don't want to convert your IRA to a Roth IRA, you can make new contributions to a non-deductible IRA and ultimately convert to a Roth after that. There is no tax consequence to doing this if you are converting after-tax funds to a Roth IRA (but only if you have no other IRA accounts including Simple IRAs or SEP IRAs which would trigger something called the pro-rata rule!). This would make a partially taxable conversion when you do this.

Possible changes to Roth IRAs!

However, all of this could change in the coming months with tax reform. Here are some potential changes coming down the road

- Backdoor Roth IRAs could be removed
- If your income is over threshold ($400K for single filers, and $450K for married filing jointly) – Roth conversions could go away
- If your accounts are over $10M and between $20M that the IRS could require RMDs from Roth IRAs to get them under this threshold

I hope this is helpful to you and you enjoy the fascinating world of Roth IRAs!!

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