



Westwood®

Roth Conversions

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While we cannot control the volatility in the markets, taking a step back and maintaining a long-term view can present opportunities in times of turbulence — one of which is taking advantage of lower valuations by way of a Roth Conversion.

A Roth conversion is the process of converting a partial amount, or the full amount, of an existing Traditional IRA or IRA rollover into a Roth IRA.

The conversion costs money, but with proper planning, can pay for itself in the future. Here's why:

Traditional IRAs are funded with pretax dollars and grow tax deferred. Once withdrawals begin, which must be no later than the account owner's age 72, all distributions are taxed at prevailing ordinary income tax rates.

Alternatively, Roth IRAs are funded with after-tax dollars. Therefore, qualifying distributions are tax free and there is no mandate on withdrawing the assets at any specific age.

Assume an individual has amassed \$1,000,000 in retirement assets and needs \$100,000 in annual distributions during retirement to fund lifestyle expenses. Due to income limitations, they were not able to save for retirement using a Roth IRA and instead used a Traditional IRA.

Assuming a 24% income tax bracket, this individual would incur \$24,000 in income tax liability annually, which would increase their needed distribution amount from \$100,000 to at least \$124,000 — costing more in taxes and leading to a quicker drawdown of their retirement assets.

Conversely, if this same individual had converted portions of their Traditional IRA to a Roth IRA over time, and having amassed \$1,000,000 in Roth IRA assets instead, qualified subsequent distributions would be tax free — extending the life of the account and reducing income tax liability in retirement.

Additionally, tax-free Roth IRA withdrawals can help minimize other taxes or surcharges such as Medicare Part B and Part D, which increase as income grows. They can also help to stay below the threshold for the 3.8% surtax on net investment income.

Roth conversions can be partial or full conversions. The amount converted is taxed at prevailing ordinary income tax rates in the year of the conversion, and then continue to grow tax deferred. Qualified Roth IRA distributions rules are:

- Withdrawals are taken after age 59½
- Withdrawals must be taken after a five-year holding period

Exceptions to these two rules are permitted for the following:

- Up to \$10,000 lifetime max for first home purchase
- Qualified education expenses
- Qualified expenses related to birth or adoption
- Account owner becomes disabled or passes away
- Unreimbursed medical expenses or health insurance

Contributions (principal) can always be withdrawn tax and penalty free, but if you have not met any of the qualifying events listed above, you may be assessed tax on the gains within the account and/or a 10% penalty.

Here are some indicators of a good time to consider converting:

- Individuals experiencing low-income years
- Individuals experiencing depressed asset values within their Traditional IRA(s)
- Individuals expecting income tax rates to be higher in retirement than what they are currently

Lastly, Roth IRA conversions are most beneficial when the tax incurred the year of the conversion can be paid with assets outside of the IRA. This is because there will likely be no future contributions to the converted Roth, so the larger the asset base converted, the greater the likelihood of amassing more tax-free wealth.

If you think a Roth conversion might benefit your retirement planning, your advisor would be happy to assist you in the process.