When Do You Convert Into a Roth IRA?

So much depends on the investor's best guess about future tax rates.

By Jeff Brown, Contributor |Oct. 23, 2017

With stocks hitting new highs and a move in Washington to reduce income tax rates, investors face a decision. Does

it make sense to convert a traditional individual retirement account into a tax-free Roth?

This has always been a dilemma because it depends on unknowns like future tax rates, inflation, investment returns and how long the investor will live. Tax rate changes being pushed by President Donald Trump and Republicans in Congress add a layer of uncertainty, since a conversion triggers an income tax for the year it is done.

Still, getting it right can save the investor a bundle in taxes over the long term, so many experts recommend tackling the issue as best you can. The rules are basically the same for traditional and Roth 401(k)s as well as IRAs.

It takes years for an IRA to grow enough to justify paying the conversion tax. "The ideal candidates for Roth conversion would start with people who for sure won't need the money for at least five to 10 years," says James Barnash, planner for SGL Financial in Buffalo Grove, Illinois.

So much depends on the investor's best guess about future tax rates, he says.

As most investors know, individual retirement accounts come in two flavors. First is the traditional IRA that for many investors offers a tax deduction on contributions and tax deferral on investment gains. Income tax is charged on withdrawals and the investor must start taking money out after turning 70.5 years.

The newer Roth IRA has no deduction on contributions but no tax on withdrawals, and no requirement that distributions ever be taken. That allows investments to compound tax-free indefinitely.

Investors with traditional IRAs have the right to convert to Roth IRAs without incurring the 10 percent penalty generally charged against withdrawals from a traditional IRA before age 59.5, but there's a catch: the converted sum is considered a withdrawal and taxed as income.

So you get hit with a tax bill one way or another. The rule of thumb is that a conversion will probably pay off if you expect to be in a higher tax bracket later. Converting would mean paying at today's low rate to avoid a higher rate in the future.

But a conversion would not make sense if the future rate would be lower, since you'd pay at a high rate to convert, and miss out on the lower rate you would pay later if you kept the traditional IRA.

Projecting future tax rates is always a gamble, since no one knows what Washington will do years down the road, and an investor who converted today and paid a 25 percent tax surely regret it if a tax cut would reduce the rate to 12 percent.

Investors can convert just a portion of the traditional account each year, or just when conditions are right – switching just enough to avoid going up to a higher tax bracket.

"Since most people are going to do these conversions over a period of time to keep the tax bill as low as possible, the market situation should not be a factor," says Nick Sloane, president of Sloane Wealth Management in Warrenville, Illinois. "Tax reform could be less of an issue, too. If people think taxes will be cut and stay low forever, I think they are living in a parallel universe."

The outcome of tax-rate discussions is impossible to predict. Though Republicans control Congress and the White House, they've had trouble getting measures passed, and could have a sticky time if it appears their proposals would increase federal deficits. And it's always possible a tax cut done in the next few months would be reversed later.

Investors should also keep in mind that the stock market's big run-up of the past few years has produced a lot of gains to be taxed after a conversion. All else being equal, the tax hit would be lower if one converted when prices were down. But although downturns are a fact of life in investing, stocks could keep climbing, meaning a conversion today would be less costly than one done later.

Ben Westerman, senior vice president of HM Capital Management in St. Louis, Missouri, notes that many retirees can withdraw from a traditional IRA to convert or simply raise cash without facing a big tax bill.

"This is due to the fact that most retirees do not have any ordinary income and thus are in the lowest tax brackets," he says. "These funds can be used for current spending and/or converted to a Roth IRA." Note, though, that the IRA withdrawals can put you into a higher tax bracket because they count as income.

It's important, then, to examine your tax situation carefully before pulling money from a traditional IRA.

"An ideal candidate for a Roth conversion is a young retiree with a large traditional IRA, has not started Social Security and is in a low tax bracket," says Michael Palazzolo, president of Fintentional, a fee-only financial firm in Birmingham, Michigan.

Converting to a Roth, or simply taking money out, would also cut future tax by reducing the size of the traditional IRAs so that less has to be taken from them after age 70.5, he says. Those required minimum distributions are percentages based on government life expectancy tables.

"Candidates in high tax brackets should be cautious about completing Roth conversions since the resulting income tax liability reduces the benefit of the conversion," Palazzolo says. "Waiting to see if the tax rates are reduced makes sense for someone in a high tax bracket. For someone already in a low tax bracket, they should still consider a partial conversion."

One rule of thumb: tax on a conversion should be paid out of other funds, and not be taken from the conversion, which could reduce your holdings so much they might never recover to where they would have been if you had stayed with the traditional IRA.

"One part of a decision is where will the money come from to pay the tax," Sloane says. "It should come from other, non-taxable or already taxed funds. Otherwise, you have to keep taking money out of the IRA to pay additional tax."

Standard advice also says that the longer your holdings have to grow, the more likely a conversion will leave you ahead. So if you're in good health and people in your family tend to live a long time, a conversion could be a winner.

Because heirs generally do not have to pay tax on withdrawals from an inherited IRA, a conversion can pay off even if the investor is not concerned about using the account for his or her own retirement, Sloane says.

"One reason for doing a conversion is not to benefit oneself, but for the legacy," he says. "Tax-free income will more greatly benefit younger generations since tax increases in their lifetimes are far more likely. Children and grandchildren will otherwise pay for our collective financial sins. If the conversion tax is affordable and if a legacy is important, that would be something for me to suggest."

If it all seems like too many variables to nail down, keep in mind the law offers an escape hatch: a recharacterization allows the investor to convert the Roth back into a traditional IRA. This reversal must generally be done by mid-October of the year after the conversion, and eliminates the conversion tax. So if you converted this year and Washington cut your income tax rate for 2018 and later, you could return your money to a traditional IRA and then do another conversion when the tax bite would be lower.

Tax reform as Republicans have proposed "is unlikely," Sloane says. "The same uncertainty applies to the stock market. You can still recharacterize next year if a correction occurs before (the 2018 deadline)."