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Should You Convert Your Traditional IRA to a Roth IRA?

If your income is likely to take a hit in 2020 due to the coronavirus pandemic and you have a sizeable balance in a tax-deferred IRA, this may be a good year to consider a Roth IRA conversion. In some states, unemployment is not considered taxable income (make certain you understand your state's rules), which may help keep your taxable income low.

A traditional IRA, where contributions are deducted from taxable income, is in many ways a ticking tax bomb. Gains accumulate tax free over the life of the account, but all distributions are taxed at your personal tax rate when withdrawn in retirement. If you have done a good job of accumulating assets in your IRA, required minimum distributions could put you in a relatively high tax bracket, making your Social Security payments taxable and increasing the amount you will be required to pay for Medicare.

Prior to the 2017 tax law changes, if you died with a sizable balance in your IRA, your beneficiaries could "stretch" that balance out over their lifetime with an inherited IRA. Now, for most non-spouse beneficiaries (there are four exceptions), inherited IRA funds must be distributed within ten years, potentially creating adverse tax consequences for your heirs.

A Roth IRA is funded with after-tax contributions. Federal and state income taxes have already been paid on contributions to the account. Gains then accrue tax free over the life of the account. When Roth IRA distributions are taken in retirement, no income taxes are due. Because Roth withdrawals are not counted in your income, they may not affect your Medicare costs or the taxability of your Social Security payments. In addition, you can withdraw your original contributions at any time, regardless of your age, without an early withdrawal penalty because you have already paid taxes on those funds. Regular withdrawals can begin at 59½, similar to a tax-deferred IRA. In addition, a Roth IRA does not have Required Minimum Distributions.

Converting a tax-deferred IRA to a Roth IRA has one major requirement. You must pay income taxes on the full amount rolled over into the Roth account. If you use funds from the tax-deferred IRA account to pay the taxes, it counts as a withdrawal and may be subject to an early withdrawal penalty as well as personal income taxes. Because the rollover amount counts as

income, it could push your personal income tax rate into a higher bracket, which is why making a rollover at a time when you have minimal income can be beneficial. Tax brackets are also at their lowest level in many years as a result of the 2017 tax law changes.

If you believe, as we do, that higher personal income taxes at both the state and federal level may be inevitable due to the financial impact of the coronavirus pandemic, a Roth IRA may minimize your taxes in retirement and provide you with greater after-tax retirement income.

To explore the benefits of a ROTH IRA conversion and to make certain you follow the rules and avoid any penalties, talk to your financial advisor.

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