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Balance sheet

Roth IRA Conversions

By Terry Schleucher

A Roth conversion is a strategy that allows you to pay income taxes on some or all of your retirement assets today, rather than when you withdraw those assets in retirement. It is done by converting a Traditional IRA to a Roth IRA, and, with few exceptions, anyone is eligible to convert regardless of age or income.

Roth IRA's have two major advantages over Traditional IRA's. First, distributions from Traditional IRA's are taxed as ordinary income whereas Roth IRA distributions are tax-free and penalty-free as long as the Roth IRA is at least five years or older and one of the following conditions has been met: you reach age 59½, die, become disabled, or make a qualified first-time home purchase. Secondly, Traditional IRA's are subject to the lifetime required minimum distribution rules that generally require minimum annual distributions to commence in the year following the year in which the IRA owner attains age 70½. In contrast, Roth IRA's are not subject to the lifetime required minimum distribution rules.

The switch from a Traditional IRA to a Roth IRA is not income tax-free. Instead, it is subject to tax as if it were distributed from the Traditional IRA, but generally is not subject to the 10 percent premature distribution tax. Fortunately, taxpayers who convert to Roth IRA's have the unique ability to determine when to pay the tax on the conversion—in the year of the conversion, or in the following year. And that could be beneficial in the situation we are in today when it is not clear whether tax reform will yield lower tax rates next year.

Should Congress fail to enact tax reform, or if the reform fails to yield a lower 2018 marginal rate, taxpayers making a Roth IRA conversion this year simply will report the transaction on their 2017 return. But if tax reform succeeds, and the taxpayer's marginal rate will be lower next year than this year, the taxpayer can shift income recognition of the conversion from 2017 to 2018 by "recharacterizing" or reversing the original conversion by the due date (plus extensions) of the return, i.e. October 15, 2018. Taxpayer can then do a reconversion of the Traditional IRA to the Roth IRA in 2018.

Keep your end goal in mind when deciding to convert to a Roth. Factors to consider would be: will I be able to afford the taxes due? What is my tax rate now, and what will it be in the future? When do I need to make withdrawals? Also, converting a Traditional IRA to a Roth IRA is not an all-or-nothing decision – converting a portion of your Traditional IRA's is also a strategy to consider.