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Cherry Tree Wealth Management

CHERRY TREE WEALTH INSIGHTS: Published by Keith Tufte, Investment Advisor at Cherry Tree Wealth Management, LLC, with insights on investing and wealth management.

ROTH IRA CONVERSIONS—WHEN DOES IT MAKE SENSE?

There are many factors to consider to decide if a Roth IRA conversion makes sense, and if so, how much Roth conversion to do each year. Converting some of your IRA account to Roth can be very smart and add a great deal of value and tax savings over time.

What is the perfect time to do Roth conversions?

A good time to consider doing Roth conversions is when your income (and tax rate) drops considerably below where it is likely to be in the future. For many people that is the years following retirement but before they start taking Social Security benefits and before they are subject to IRA required minimum distributions (RMDs) at age 73. This is often age 65-72 for many people. For many people with large ($1M+) IRA accounts, the start of IRA required distributions at age 73 often pushes them into a higher income tax bracket/rate. Doing some Roth conversion after a significant drop in the stock market can be wise.

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Who is the ideal candidate to do Roth conversions?

A good candidate to do Roth conversions is someone who expects their future income tax rate to be higher than their current tax rate. They would also have a large IRA account size (often over $1 million), and a large IRA account relative to their other types of investment accounts. The ideal client also has plenty of money in savings and/or brokerage accounts to pay the tax bill on the Roth conversion now, and is open minded to paying income taxes now (voluntarily) to "invest" in a better future tax situation for themselves. Wealthy people who do Roth conversions could save future income taxes and estate taxes.

Factors to consider relative to Roth conversions:

Low current tax rate. Is your current income tax rate lower than the expected income tax rate in the future? This is the first and most important screen to see if a Roth conversion makes sense. The bigger the expected jump in your future income tax rate, the more a Roth conversion makes sense.

Large IRA account. Is the IRA account large (often $1M or more), and large relative to your other type of investment accounts? If the IRA account is the majority of your assets, you are not well diversified relative to future income taxes and tax rates. The larger the IRA is in absolute terms the better for Roth conversion.

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Other accounts to pay the tax? You will need other savings/investment accounts with enough money to pay the income tax on the Roth conversion. It makes less sense to pay the income taxes on the Roth conversion out of the IRA itself as that only creates more income taxes. If you have limited dollars in other types of accounts, simply taking money out of the IRA for living expenses may be the best solution.

Will your future income exceed $250K (couple)? Your future adjusted gross income level of $250K (couple) and $200K (single) is relevant as that is when the 3.8% Medicare surtax on income kicks in. If your current taxable income is below these levels, but future income levels are above it then a Roth conversion could be favorable.

Is your future taxable income going to go up enough so that it triggers higher Medicare premiums? If so, a Roth conversion can make more sense.

How is your health and life expectancy? A lower life expectancy makes a Roth conversion likely less advantageous as it is an "investment" with a long payback period, and there is less time for the Roth account to grow tax-free.

Will your estate go to charity or to your children? If much of the estate (or the IRA account) will go to charity, then a Roth conversion makes less sense because charities don't pay tax.

What will the tax rate likely be for your children at your death relative to your current marginal tax rate (when you do a Roth conversion)? It is likely that 50%-90%+ of your current IRA size will be passed on to your children and subject to the 10-year inherited IRA distribution rules. Thus, much of the IRA is likely to be taxed at your children's future income tax rate, not your age 73+ tax rate. If your kid's future tax rates are likely to be the same or lower than your current tax rate, then a Roth conversion makes less sense.

How many kids do you have? Since the IRA will likely be split, the more kids you have the lower the likely tax rate on the inherited IRAs will be and the less a Roth conversion may make sense.

Are you likely to move to a low(er) tax state in retirement? Do your kids live in low(er) tax states? If so, then Roth conversion now could make less sense. Do the Roth conversion after moving to a lower tax state.

Do you have unrealized capital gains in taxable brokerage accounts? These could possibly be "harvested" at 0% capital gains tax rates or very low tax rates first, before considering Roth IRA conversion.

Are you open minded to pay income taxes now to do the Roth conversion? With a Roth conversion you are paying income taxes voluntarily now, many years before required, to "invest' in a better future tax situation. Some people are more open to this than others.

Cherry Tree Wealth Management, LLC (CTW) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Keith Tufte, has over 25 years of successful investment management experience as a Wall Street Analyst, Mutual Fund Portfolio Manager, Director of Equity Research for a major mutual fund firm, Hedge Fund Portfolio Manager, and Wealth Management Advisor. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at http://www.cherrytree.com.

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