

Financial Planning **Update**

When do Roth conversions make sense?



For years, higher wage-earners were precluded from enjoying the tax-free growth and distributions of Roth IRAs because of income limits. However, starting in 2010, the IRS lifted the wage limits on Roth conversions. This means that all investors, regardless of their income level, are eligible to convert a traditional IRA to a Roth IRA. But that doesn't mean everyone should. Here's a look at some situations when Roth conversions may make sense—and when they may not.

Roth IRAs can be a smart way to accumulate wealth for retirement and for future generations. Unlike a traditional IRA, with a Roth you never pay tax on qualified distributions (as long as you own the IRA for five years) and you don't have to take required minimum distributions (RMDs). Since high wage-earners can't contribute directly to a Roth IRA, the only way to take advantage of the tax-free growth is to convert an existing IRA to a Roth.

In general, converting to a Roth may be a good move if you are in a lower tax bracket, the converted amount won't push you into a higher bracket, and you have money outside of your IRA to pay the taxes, which will be due for the tax year in which you make the conversion. You'll also want to consider your legacy goals, as a Roth IRA can benefit multiple generations.

A Roth conversion may make sense if...

Your current tax bracket is relatively low.

When you convert a traditional IRA to a Roth, you pay ordinary income taxes on the amount you convert. Depending on the size of your IRA, that could equal a large tax bill. If you're a young investor and have not yet reached your earnings peak, or if you're an early retiree, your tax bracket today will likely be lower than it will be when you start taking RMDs. In that case, converting all or part of an IRA now may be more advantageous than not converting at all.

Consider a hypothetical recently retired couple, both 62 years old, with this situation:

- Taxable investments: \$2,500,000
- Traditional IRA assets: \$2,500,000
- 6% projected growth rate on investments
- Plan to delay Social Security to age 70
- They believe taxable investments are sufficient to cover expenses until Social Security benefits and RMDs will begin
- Sufficient taxable investments to pay tax on Roth conversions

From age 62 to 70, the couple's only taxable income will be investment income, which after taking tax deductions puts them in the 15% marginal tax bracket. Their accountant has estimated that they can realize an additional \$40,000 in income before they get taxed at a higher marginal tax rate.

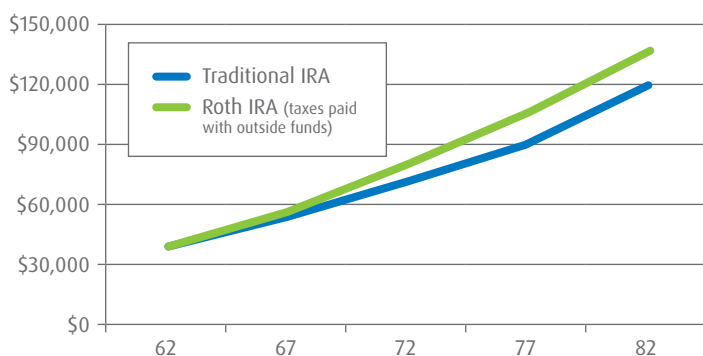
At age 70 the couple's taxable income is projected to increase. Assuming no Roth conversions, at age 70½ the required distribution from their IRA will equal roughly \$150,000. Considering income from Social Security and taxable investments, these required distributions will be taxed mostly at a 28% rate. The client has determined that the \$40,000 in converted funds will not be needed for at least 20 years.

Over the next 8 years this couple has the opportunity to annually convert \$40,000 of traditional IRA assets to a Roth IRA at a 15% tax rate. Because the tax rate is projected to be higher after age 70, there is a tax benefit achieved by converting at the 15% tax rate. Converting \$40,000 this year increases the after tax value in 20 years by \$15,877. Assuming they are able to convert \$40,000 each year over the next 8 years they will have converted \$320,000 providing an after tax benefit of over \$127,000.

In situations where your tax rate is lower now and will likely be higher in the future, converting and paying taxes now is likely to provide tax savings. Additionally, the longer the time horizon the greater the advantage of the conversion.

The graph below compares the future after tax value of the Traditional IRA versus a Roth IRA through age 82.

After-tax balance



Amounts accumulated at age 82	No Conversion* (Traditional IRA)	Roth Conversion (Taxes paid with outside funds)
Before tax	\$141,435	\$135,982
After tax	\$120,105	\$135,982

*Includes additional taxable funds to compensate for the money that was not lost to taxes under the No Conversion scenario. If over age 70½, the side fund assumes deposits of the remainder of any required minimum distributions after taxes have been paid. The growth on this account is taxed each year.

State income tax treatment of the Roth IRA conversion and subsequent distributions from the Roth IRA may vary depending upon the state of residence.

You want flexibility around taking withdrawals in retirement.

No one knows for sure whether tax rates will be higher or lower in the future. However, if you have some assets in a traditional IRA and some in a Roth IRA, you can gain flexibility. For example, you are required to take an RMD every year from the traditional IRA starting at age 70½ (and pay tax on amounts not taxed before). But, since distributions are not required from a Roth IRA, you can decide, year to year, whether to take more income from the Roth (tax-free) or let it remain invested. As illustrated in the earlier example, this may prevent you from being taxed at the higher tax rates.

You don't expect to need the income from RMDs.

Many investors will have other sources of income in retirement and would rather preserve the value in their IRAs for their later retirement years, or for their heirs. There are no RMDs with a Roth IRA, so the money can stay invested and benefit from tax-free growth for a longer period of time.

You want to leave most of your IRA assets to your heirs.

A Roth IRA can be an effective multi-generational or legacy planning tool that allows you to stretch your giving over two to three generations. Spouses who inherit a Roth IRA can take ownership of it and allow the assets to continue to grow tax-free for as long as they live.

Second-level beneficiaries, like children, must take distributions, but they can do so according to their own life tables (which are based on their age and life expectancy). Third-level beneficiaries, such as grandchildren, must take distributions based on the prior beneficiary's life table. Importantly, because you pay tax on the assets when you convert, you won't burden your heirs with taxes. They inherit the money completely tax-free.

A Roth conversion may not make sense if...

The conversion pushes you into a higher tax bracket.

The amount of a Roth conversion counts as income in the year you convert. If the conversion bumps you up into a higher tax bracket, you may want to hold off. Also, taking a large Roth conversion could subject you to additional taxes that high-income earners face, including the 3.8% net investment income tax, the phase-out of itemized deductions, and the increased cost of social services, such as Medicare. Be sure to consult with a tax advisor to determine your potential tax liability before you convert.

You don't have sufficient assets outside your IRA to pay the taxes.

Ideally, it's best to pay the conversion taxes from assets other than your IRA. If you are under age 59½, IRA assets that you withdraw but don't convert (such as those used to pay the tax bill) are subject to an early withdrawal penalty. If you don't have other assets to cover the tax bill, you should probably not convert.

You want to leave your retirement assets to a charity.

If you've earmarked the pool of money in your traditional IRA for charity, then converting would not be a good strategy. Charities do not pay tax on assets donated from an IRA—whether traditional or Roth. If you don't convert you'll pay tax on your RMDs, and those will reduce the value of the IRA. However, your estate can take a deduction for the full amount donated, and the charity will inherit the remaining assets tax-free.

Continued

IRAs at a glance.

Traditional IRA	Roth IRA
Earnings grow tax-deferred.	Earnings grow tax-free.
You pay ordinary income tax on withdrawals in retirement, but only on the portion of your withdrawal that comes from pre-tax contributions and earnings. After-tax contributions are not taxed at withdrawal.	You pay no tax on withdrawals in retirement—including contributions, earnings and conversion amounts—provided you've owned the Roth IRA for five years.
There are income limits on tax-deductible contributions but anyone can make nontax-deductible contributions.	There are income limits on contributions, which are always made after-tax and are not tax-deductible.

You plan to move to a state with low or no state income tax.

It is not uncommon for retirees to relocate to a different state after they retire. Depending on the state this could increase or decrease future tax rates. There are seven states without income tax. If you live in a state with income tax but plan to move to one of the states without income tax, you may want to delay conversion until you change your state of residency.

Take, for example, a single California resident who has taxable income of only \$50,000 and is considering converting \$100,000 of her traditional IRA. If she goes through with this conversion while a California resident, she will owe state income tax of roughly \$9,300. However, if she plans to move to a state without income tax, she can save the \$9,300 by waiting until she changes her state or residence.

Some states offer partial exclusions for retirement income. For example, Illinois does not tax income from IRAs and pensions. Before converting, it's important to know how your state will tax the conversion.

Seven states without income tax

Alaska	Texas	Many other states provide limited tax benefits on IRA distributions. The rules vary from state to state. Ask your tax advisor about the rules for your state.
Florida	Washington	
Nevada	Wyoming	
South Dakota		

Other considerations

Do I have to convert my entire IRA?

No. You can convert all or part of an existing IRA to a Roth IRA. This approach can give you added flexibility in a number of situations:

- *If converting the entire amount would push you into a higher federal income tax bracket.* You can “fill up the bracket,” that is, convert the maximum amount possible while still keeping your income within your existing tax bracket. That way you're not paying additional tax on your other income.
- *If you want to give some of your assets to charity.* Leave the amount you want to give to charity in the original IRA, factoring in RMDs, and convert the rest. The charity will inherit the assets tax-free.
- *If you will need some income from the IRA but want to leave a portion for later generations.* Convert the amount you want to leave to your heirs and they will inherit it tax-free. Meanwhile, you'll have what remains in your original IRA for yourself.

What if I change my mind?

You may want to undo, or recharacterize, a Roth conversion for a few reasons:

- Your taxable income in the year you converted ended up being higher than you expected, so the additional income from the Roth IRA conversion bumped you into a higher tax bracket.
- You now believe that your taxable income (and therefore your income tax rate) in retirement will be lower than you expected.
- You don't have enough cash on hand to pay the taxes.

Continued



Carl Hibben is a Senior Financial Planner with BMO Private Bank. Carl specializes in providing customized financial planning solutions to high net worth individuals and families as part of an overall personal wealth management strategy. He joined the organization in 2010, and has over 11 years of experience in the financial industry.

Carl earned his B.S. in Financial Planning from Purdue University. He is currently pursuing his Master of Science in Wealth Management from DePaul University—Chicago, IL. He is a CERTIFIED FINANCIAL PLANNER™.

You must complete a recharacterization by the due date for filing your prior-year federal tax return, including extensions. This is typically on or about October 15. Generally, you can recharacterize all or part of the amount you converted. And if you change your mind again, you can reconvert to a Roth IRA in the year after the conversion, or 30 days after the recharacterization, whichever is later.

Can I contribute more money after I convert?

That depends on your income. First, at a minimum you must have earned income equal to the IRA contribution amount. Second, if you're married filing jointly, you can contribute to a Roth IRA if your adjusted gross income is less than \$193,000. If you're single, the amount is \$131,000.

If I don't have an IRA to convert now, can I still take advantage of the Roth structure?

If your income is too high to contribute to a Roth you can open a traditional IRA and make a non-deductible contribution. The IRA can then be converted to a Roth IRA. As long as you don't have any other IRAs and you convert before there is any growth, there would be no tax due at conversion. Technically, you can repeat this every year. The timing of this "Backdoor Roth IRA" strategy is very important, so please be sure to consult with a tax advisor.

A Roth conversion may be an effective way for you to manage and preserve retirement wealth. When the conversion is structured in a way that minimizes the immediate tax burden, you can gain greater income flexibility while passing tax-free assets on to future generations. Check with your tax advisor to see if a Roth conversion makes sense for your situation.

Feel confident about your future

BMO Private Bank—its professionals, its disciplined approach, its comprehensive and innovative advisory platform—can provide financial peace of mind.

For greater confidence in your future, call your BMO Private Bank Advisor today.

www.bmoprivatebank.com



Certified Financial Planner Board of Standards Inc. owns the certification marks CFP®, CERTIFIED FINANCIAL PLANNER™ and CFP® in the U.S.

BMO Private Bank is a brand name used in the United States by BMO Harris Bank N.A. Member FDIC. Not all products and services are available in every state and/or location.

This information is being used to support the promotion or marketing of the planning strategies discussed herein. This information is not intended to be legal advice or tax advice to any taxpayer and is not intended to be relied upon. BMO Harris Bank N.A. and its affiliates do not provide legal advice to clients. You should review your particular circumstances with your independent legal and tax advisors.

© BMO Financial Group (07/15)