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When Roth Conversions Do or Don't Make Sense

Favorable Condition for Roth Conversions – Potential Higher Taxation in the Future

The recent passage of the One Big Beautiful Bill Act (OBBBA) averted a scheduled increase in taxes that would have taken place at the end of 2025 as part of the Tax Cuts and Jobs Act (TCJA). While the immediate threat of a tax increase is gone, the potential exists that tax rates can change and may not always be as favorable as is currently the case. This may make paying taxes now at a known rate, and possibly lower rate, advantageous by electively implementing Roth conversions.

It may also be beneficial to initiate a Roth conversion prior to the start of Required Minimum Distributions (RMDs). Pre-RMD Roth conversions allow individuals to control the tax they pay at today's rates, rather than being forced into a larger RMD at a time when tax rates may be higher.

An anticipated change in tax filing status should also be considered. For married couples, after the first death, the surviving spouse then files as a single taxpayer, which could put them into a higher marginal tax bracket if the income they receive stays largely the same. Converting traditional IRA assets to a Roth before then can help offset this impact.

Temporary irregular income situations may also present some opportunities. An unemployed individual who has sufficient savings to bridge the gap between jobs and can cover the taxes from a Roth conversion may be able to take advantage of their temporary lower tax situation. Similarly, self-employed persons who find themselves in a situation with net operating losses for a given year, may be able to pass-through those losses, allowing them to implement a Roth conversion with less tax impact. This can be especially helpful for many small business owners and farmers.

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Favorable Conditions for Roth Conversions - The Market is Down

A bear market may allow one to convert shares at a lower price, resulting in a smaller tax liability. As Michael Kitces at Nerd's Eye View likes to call them, 'discounted' Roth conversions. Should the market recover, the increase alone could be more beneficial in a potentially tax-free Roth IRA than a traditional IRA that would still need to be taxed at some point and possibly at a higher tax rate. While nobody looks forward to the next bear market, planting the seed of a potential opportunity may provide a different perspective during a tough time.

If converting funds while the market is up is a concern for a client, conversion-cost averaging may be a beneficial strategy . . . similar to dollar cost averaging with contributions. If monthly or quarterly is too often, "bar-belling" some conversions at the beginning of the year and the rest at the end of the year may be an option to help spread the tax cost over two tax years.

Favorable Conditions for Roth Conversions - Legacy and Estate Purposes

- Most beneficiaries are now required to liquidate an inherited retirement account within 10 years. While a Roth IRA is still subject to that 10-year window, the distributions are tax free to heirs, as long as the decedent had met the five-year holding requirement.

- Funds used to pay the taxes on conversions are no longer part of the taxable estate, helping reduce the potential estate tax costs.
- Beneficiaries who may still be working may face a higher tax when inheriting traditional IRA balances. This is not a concern for an inherited Roth IRA.
- Roth IRAs do not have RMDs, allowing for longer tax-free growth and a potentially greater legacy amount to heirs.

Favorable Conditions for Roth Conversions - Honorable Mentions

- The need for after-tax retirement funds to be included in a tax-sensitive distribution plan.
- Ability to create Roth assets if income limits eliminate eligibility for Roth IRA contributions.
- Early access to retirement assets that are penalty free after the converted principal has been held for 5 years.
- Separating the after-tax from the pre-tax portion of a traditional IRA rolling to a qualified retirement plan.

Unfavorable Conditions for Roth Conversions

- For Roth conversions to work properly, there must be a way to pay the tax other than from the converted assets. If outside funds are not available, consider increasing tax withholding from paychecks.
- Insufficient time to recoup conversion expense with equivalent tax-qualified growth.
- If the conversion causes a 'tax torpedo' of additional Social Security taxation on top of the conversion.
- If the conversion causes Medicare premiums to increase.

As you can see, there are many pros and cons to Roth conversions to consider. On top of that, it can be difficult to weigh the impact of each in relation to individuals' specific situations. Roth conversions can be a complicated balancing act with many moving parts that can change each year. Therefore, you are encouraged to consult a tax professional for tax advice on this matter.

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