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Marc A. Hebert's 'Money Sense': Converting your traditional IRA to a Roth IRA

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THERE IS still time this year to consider one opportunity to make a financial move: converting your traditional IRA to a Roth IRA. This refers to the process of taking funds in your traditional IRA, paying the tax on it, and moving the funds to a Roth IRA.

You can choose to convert your entire traditional IRA account or just a portion of it.

Just what is a Roth IRA? A Roth IRA offers you the chance for tax-free income during your retirement years. This is in part due to the fact that Roth IRA contributions are not tax-deductible. The earnings in the Roth account grow tax-free. Qualified withdrawals are also free of federal income tax. This may be true of state income taxes too, but it's best to check your state tax law for confirmation.



Usually, to be eligible for qualified distributions, a Roth IRA account must have been opened for five years. In addition, the holder must be age 59½ or older, permanently disabled, or is receiving the account as a distribution due to death.

These are the general rules. There may be other exceptions that apply to your situation.

The ability to convert funds in a traditional IRA to a Roth IRA does not depend on your earnings or tax filing status. There is no limit on the amount you can convert.

You can also convert funds more than once during a year. The caveat to this is for inherited accounts. For beneficiaries other than spouses, an inherited traditional IRA cannot be converted to a Roth IRA.

On the other hand, a spousal beneficiary can choose to treat the inherited traditional IRA as his/her own. If this is done, the spouse has the ability to convert the account to a Roth.

Since traditional IRA contributions are usually made on a tax deductible basis, converting the funds to a Roth means paying federal income taxes on the converted amount. These are paid in the year of conversion. Once again, be sure to check your state tax situation. Doing a Roth conversion could result in a higher tax bracket and more taxes paid for that given year. You will need to weigh these taxes against the potential to never pay income taxes on the funds again.

Unlike the traditional IRA, Roth IRAs are not subject to required minimum distributions. You will not be forced to take money from your Roth while you are alive.

So why consider a Roth IRA now? In today's environment of relatively lower tax rates, it could make sense. Assuming no tax law changes, the lower rates are due to expire at the end of 2025. Rising deficits due to the pandemic may trigger higher tax rates down the road.

Taxes are the big unknown. Converting to a Roth IRA may make sense if you feel you will be in a higher tax bracket when the funds are withdrawn. Traditional IRAs may make more sense if you feel your tax bracket will be lower when you go to use the funds.

If your traditional IRA investments have seen a decline in value, the conversion may cost you less in taxes. You may have had financial challenges this year that could translate into a lower income. Lower income and thus lower tax rates may result in more room to make a conversion before jumping into the next tax bracket.

It is important to consider how you will pay the taxes that the conversion will generate. The Roth conversion strategy works best if you have other funds to pay the tax due and don't use part of the traditional IRA distribution to cover them.

The end of the year is quickly approaching. This is one strategy to consider that might benefit your financial picture going forward. It could be prudent to discuss your options with a certified financial planner who is familiar with your unique situation.

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