A Closer Look

Do Roth IRA Conversions Still Make Sense?

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In Brief

- **Converting from a traditional IRA to a Roth IRA can offer wealthy individuals a tax-efficient way to leave greater wealth to heirs.**
- **While the sizeable up-front tax bill may be an impediment, the benefits of tax-free distributions for beneficiaries in most cases will significantly outweigh the costs, especially over time.**
- **With tax rate increases likely for wealthy individuals, holders of traditional IRAs may want to consider converting before tax laws change.**

Investors and tax professionals have long debated the relative merits of maintaining traditional IRA accounts or converting them to Roth IRAs. Unlike a traditional IRA, where normal distributions[1] are taxable income, qualified Roth IRA distributions[2] are entirely free from income taxes.

The trade-off is the sizeable tax bill owed at the time of conversion. For anyone whose IRA account will be an important source of retirement income, the debate comes down to this: Will it truly be less expensive to pay taxes now, or should I stick with my traditional IRA and pay later, when I may be in a lower tax bracket?

Yet for wealthy individuals who won't necessarily need their retirement account for personal income, the choice may be much clearer. Especially at a time when tax rate increases appear imminent, Roth conversions may offer a uniquely advantageous and tax-efficient way to pass wealth along to heirs. Here are questions to consider:

How Does a Roth Conversion Work, and What Are the Advantages?

A Roth IRA conversion involves transferring assets from a traditional IRA into a new Roth IRA account, typically within the same institution. Once in the new account, the assets will grow on a tax-free basis, not just tax deferred as with the traditional IRA. Because taxes have already been paid, no tax is owed when qualified distributions are made. Moreover, while owners of a traditional IRA must take required minimum distributions (RMDs) beginning at age 72, no RMDs are required with Roth IRAs.

As such, if you are planning to leave the account to an heir, assets can continue to grow intact throughout your lifetime. Once your beneficiary inherits the account, he or she has a 10-year time frame to take distributions — thus giving the assets that much more time to compound and grow. Prior to the SECURE Act of 2019, the assets could continue to grow throughout the beneficiary's lifetime. But even the 10-year horizon gives assets an effective window for growth.

1 A normal distribution is any distribution taken after you reach age 59 1/2. Normal distributions are taxable income but incur no penalties.
2 Qualified Roth distributions generally are any distributions taken after the Roth IRA has been open for at least five years and the account holder reaches age 59 1/2 (or becomes permanently disabled or dies). Qualified distributions incur no income taxes or penalties.

Because the Roth is a new account, you must complete a new beneficiary form. Keep in mind that Roth IRAs, like traditional IRAs, will be governed by the beneficiary designation form and not by your will. Therefore, it's critical to periodically review your beneficiary designation form to make sure it reflects your objectives, and to maintain a copy.

What Taxes Will I Owe if I Convert?

You will owe income tax on the amount converted, based on your federal income tax bracket. If a traditional IRA holds $1 million in assets and is converted in full, and you are in the top (37%) bracket, you will incur $370,000 in additional federal income taxes in the year of the conversion.

Without question, that is a sizeable tax bill, and sticker shock is a primary reason people resist converting. Yet our extensive experience tells us that, in the end, the benefits of converting will very likely more than offset that one-time cost as the amount of tax-free income for heirs expands over time.

Consider a 65-year-old individual with $1 million in a traditional IRA. She converts the traditional IRA to a Roth this year and uses $370,000 from a nonretirement account to pay the tax. If she passes away in 2042, leaving the Roth to a beneficiary, our calculations show that the heir could receive about $430,000 more than if the original owner hands down the traditional IRA plus the nonretirement account. If the beneficiary then gives the Roth another 10 years to grow intact, the difference could expand to $1.3 million (see Case Study, below).

It's important to note that, depending on where you live, you may also owe state income taxes on top of federal taxes when you convert. Yet keep in mind that your beneficiary will have the advantage of paying no state income tax (or federal tax) when he or she withdraws the money. And if you live in a state with low or no state income tax and your beneficiary lives in a state with high income tax, the benefit of conversion only magnifies. Either way, when you consider a conversion, ask your tax advisor how state income taxes come into play.

What's the Best Time to Convert?

There are no age limits for converting from a traditional to a Roth IRA, so timing should be based on a careful assessment of your individual needs and goals.

For those who already know they want to convert, the likelihood that Congress will raise tax rates for wealthy individuals may provide an incentive to act while taxes remain at their current levels.

Likewise, if you're nearing age 72, you may want to convert before having to take RMDs from your traditional IRA, thus diluting the amount you can potentially leave for your beneficiary.

Must I Convert My Entire IRA All at Once?

As with the timing, the choice is yours. Holders of traditional IRAs are free to convert all or a portion of an IRA, depending on their situation and needs. Because converting a large IRA will generate a sizeable tax bill, even those who plan to convert their entire account may choose to do so over a period of years to spread their tax payments over multiple tax years. One advantage of converting in tranches or over several years is to lessen the impact of market volatility. A conversion made during a market high might result in an outsized tax bill, especially if the market drops lower shortly after conversion.

Another possible reason to stretch the conversion is to avoid going into the top tax bracket in any given year. Wealthy clients may assume they are in the top federal tax bracket anyway, but if the majority of their income comes through dividends or long-term capital gains, they may not be. Some individuals may reduce the tax cost associated with Roth conversions by increasing planned charitable giving in the year or years of conversion. Your tax professional can help you better understand which timing conversion strategy is best.

Case Study: The Long-Term Power of Tax-Free Distributions

Sarah is a hypothetical 65-year-old, with a traditional IRA currently valued at $1 million, plus $370,000 in a nonretirement account. She wants to leave as much of that as possible for the benefit of a grown child. The table below is based on the following scenarios.

- **Scenario 1 — Traditional IRA**. The traditional IRA grows at a 7.2% hypothetical pretax rate of return. In 2028, Sarah turns 72 and must take required minimum distributions (RMDs), which she'll deposit in the nonretirement account. That account will grow at a hypothetical 6.1% after-tax rate of return.
- **Scenario 2 — Roth IRA conversion.** The nonretirement account is used to pay tax due upon converting from a traditional to a Roth IRA. The Roth IRA will grow at a 7.2% hypothetical pretax rate of return, with no RMDs.

	Scenario 1	**Scenario 2**	
	Traditional IRA plus nonretirement account	Roth IRA	Cost or Benefit of Roth conversion
2021 (Starting balance)	$1,370,000	$1,000,000	$0*
2032	$2,140,487 After taxes	$2,238,775 No additional taxes owed	+$98,288
2042 (Assets transition to beneficiary upon Sarah's passing)	$4,056,655 After taxes	$4,487,022 No additional taxes owed	+$430,367
2052 (Beneficiary takes lump-sum distribution)	$7,654,203 After taxes	$8,993,030 No additional taxes owed	+$1,338,827

* The traditional IRA has an embedded $370,000 tax burden.

What Risks Should I Consider?

As with any investment strategy, a Roth conversion does contain risks and may not be right for every situation or investor. Stocks or other assets in the account may not grow at the expected levels or could even decline.

Nor is there any sure way of predicting long-term tax policies. Though increases are a prominent topic right now, a substantial decrease in the marginal tax rate down the road could limit the advantages of conversion. Or you may be concerned about other policy changes. For example, though improbable, some taxpayers fear that Congress at some point may try to tax Roth distributions, just as social security benefits are subject to tax.

It's also important to carefully consider your personal financial situation. Roth conversions are most beneficial when you can comfortably pay the one-time tax bill at the time of conversion without depleting the IRA, and for those who will not need the money in the converted Roth during their lifetime. All of which speaks to the importance of having a full analysis with your tax specialist and your Bessemer team before making decisions.

Despite these considerations, affluent individuals and families may find that Roth conversions offer an effective means to pass along assets to loved ones in a tax-efficient manner.

Roth IRAs Can Still Make Good Sense for Many

In our experience, Roth conversions are almost always beneficial for wealthy families, particularly when the IRAs aren't needed in retirement and other funds can be used to pay the associated income tax. This is true irrespective of any potential tax rate increases. As with any planning strategy, it's important to evaluate how this may fit into your long-term goals and to consult with your tax professional.

If you are interested in exploring Roth conversions further, please reach out to your client advisor or Bessemer's client tax services group for a personalized Roth IRA conversion analysis.

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