Essential Tax Techniques for Retirees: **Roth Conversions**

SMS Financial Solutions™

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Introduction

Roth conversions represent one of the most beneficial tax techniques that an advisor has in their toolbox. Transitioning money from a traditional retirement account into a Roth IRA can have significant long-term tax benefits. Clients will pay tax on their initial investment and benefit from earnings that grow tax-free, allowing for withdrawals in retirement to be exempt from tax.

Financial advisors know that taxes can hurt their clients' retirement strategies. Still, some are hesitant to address the topic either out of uncertainty surrounding compliance issues or lack of expertise in optimizing tax opportunities in retirement. However, no retirement strategy is complete without first considering the tax implications of that strategy, and Roth conversions can make a big difference for many clients in or nearing retirement.

This eBook will highlight everything you need to know about when to consider Roth conversions and how they can make a significant difference when it comes to your clients’ retirement strategies.

Why Roth Conversions Can Have a Big Impact on Your Retired Clients

There are several reasons why converting to a Roth IRA may be advantageous, specifically for retirees and their beneficiaries. For instance, a Roth conversion can help your clients grow their wealth faster. The client will pay income tax as of the conversion date, but once it's in the Roth, it will grow tax-free, and future withdrawals will be tax-free, **if certain conditions are met.**

Roth conversions are different than Roth contributions; your clients can do them in any year, regardless of income and whether they're working. Additionally, there is no contribution limit. Doing Roth conversions in otherwise lower-income years can spread out the tax liability over retirement and reduce the amount your clients pay in taxes throughout their lifetime.

Your clients in or nearing retirement may plan on passing on their wealth to their children or other beneficiaries. A beneficiary can inherit the Roth IRA free of federal income tax. Plus, right now, there are no required minimum distributions (RMDs) **during the owner's lifetime** under current rules for Roth IRAs, making Roth conversions a valuable option to continue growing wealth through retirement, so there will be more to pass on when the time comes.

What Should You Consider Before Recommending a Roth Conversion?

There are a few things advisors must consider before recommending a Roth conversion to a client. First, you should identify the tax bracket the client is in today and the starting points of adjacent tax brackets. Commonly, advisors consider Roth conversions for their clients when they have significant room before the edge of a tax bracket. By determining your client's tax bracket in advance, you'll be able to quickly find the optimal time to convert, calculate how much you should convert, and how much is too much.

It's essential to look at the lifetime impact of the conversion. By calculating the single-year impact of various conversion strategies, you can make an educated decision about the costs of a conversion. It's crucial to be aware of and help clients avoid potential pitfalls like entering a new tax bracket, Social Security tax, or unnecessary Medicare expenses.

When Is the Best Time to Convert?

Determining the best time to convert to a Roth depends heavily on the state of the market. When the market is stable, it's best to wait until later in the year — around November or December. You want to make sure that you don't accidentally bump the client into a higher tax bracket or additional Medicare premiums based on the income that arrives later in the year. For example, ordinary dividends or capital gains that get passed through mutual funds or rebalancing in the middle or at the end of the year may raise the client's tax bracket or create additional premiums.

In a down market, it's advantageous to do Roth conversions earlier in the year. You want the client's assets to recover in the Roth as opposed to the traditional IRA. Doing this will allow the client to bounce back faster since the growth will be tax-free.

How Much Should Be Converted to a Roth?

As mentioned previously, the first step when determining how much one should convert to a Roth is understanding the client's likely future tax bracket. If a client expects to be in the 22% bracket on average and wants to avoid withdrawals at that rate, a conversion might be advantageous. For example, suppose the client has a few years with lower income, perhaps right after retiring and before claiming Social Security. In that case, they may want to consider converting enough to fill the 12% bracket. Filling lower brackets intentionally in low-income years keeps those dollars from being taxed in higher brackets in future, higher-earning years. Remember, tax brackets are progressive, so it's unlikely that the client would want to convert the entire IRA.

It's also important to consider Medicare premiums. Medicare Part B and Part D premiums are based on modified adjusted gross income. For clients who are older than 65 or within two years of enrolling in Medicare, it is worth considering conversions to the point at which they would pay additional Medicare Part B and Part D surcharges.

Recent Legislation and Roth Conversions

The Tax Cuts and Jobs Act of 2017 significantly lowered marginal income tax rates for most people. The marginal income tax rate is the percentage a person is expected to pay on the next dollar of income. The marginal income tax rates are divided into seven different tax brackets. As a result of this tax rate cut, many retirees are now evaluating how much of their pre-tax investments they should convert into a Roth and how much is too much.

For instance, for clients who are likely to be in the 22% or 24% bracket for the rest of their lives, it may make sense to convert to the top of the 24% bracket since the next bracket is 32% — a full 8% higher. Also, for this group, consider the tax brackets of the client's children.

The Tax Cuts and Jobs Act will expire on Dec. 31, 2025, so adding Roth conversions to your clients' retirement strategies can help them take advantage of the current tax situation while they still can.

While Roth IRAs have always been an incredible legacy vehicle, this option is more attractive than ever due to the SECURE Act of 2019 and the subsequent SECURE Act 2.0 of 2022. These two pieces of legislation made several significant changes that affect those who focus on retirement income planning. Some of the changes include:

Required minimum distributions now begin at age 73 for those born between 1951 and 1959 and will increase to age 75 for those born after 1960. These changes give the client a few more years to do Roth conversions to bring down those eventually required minimum distributions.

There is no longer an age cap on contributions to a traditional IRA. If the client has earned income on their tax return, they are eligible to contribute. This change creates opportunities for advisors. For instance, it's common to have clients who work part-time in retirement. They have some earned income coming in but are probably mostly using non-qualified investments to live off of, and they won't have required minimum distributions until the ages set forth in SECURE Act 2.0. Those clients might be able to make an IRA contribution and qualify for a $1,000 Saver's Credit since they "look poor on paper."

Recent Legislation and Roth Conversions (Cont.)

The stretch IRA is now limited to 10 years. If an IRA account owner died after 2020, the beneficiary must get that money out within 10 years. There will be various planning techniques that will surround that 10-year distribution period for IRAs. Converting the IRA into a Roth IRA is an excellent way to relieve some of the headaches. Beneficiaries of Traditional IRAs may be subject to RMDs for years 1-9 if the IRA owner's death occurred after their required beginning date, and the entire balance must be withdrawn by the end of 10 years. Roth IRA beneficiaries are not subject to RMDs and can wait until the end of the 10th year to deplete the inherited Roth IRA.

There may be situations where life insurance is a better option than a Roth conversion. For example, suppose a client is a conservative-to-moderate investor who was unlikely to be aggressively invested in the Roth anyway. In that case, that means that they may also have other insurance needs, particularly the need for long-term care. This example could be an instance where the Roth is not likely to outperform from an investment perspective dramatically, and you meet insurance needs with life insurance or long-term care riders on life insurance.

Converting to a Roth can be a great way to keep more money in your clients' pockets, but it's important to note that once you convert to a Roth, you cannot reverse that decision — it's permanent. The right financial planning software can help you evaluate your clients' specific situations and manage all the individual elements of a retirement strategy: tax, income need, Social Security, and more to determine the best path forward.

How to Use Roth Conversions in Your Marketing Strategy

Advisors can reach new prospects by adding Roth conversions to their marketing strategy. The first step is to include information about Roth conversions in your key messages. A well-crafted message will highlight your unique benefits, target your audience, support your goal, and often have a call to action. Add those messages to your website, social channels, newsletter, and blog to amplify. Plus, you can share helpful articles, blog posts, and social graphics from other retirement income planning experts to reinforce your messages about the value of Roth conversions.

Create helpful original content about Roth conversions for prospects and clients. As we've outlined above, there are many different rules, regulations, and best practices to remember when it comes to Roth conversions. Smart advisors can take the opportunity to educate clients and prospects with blog posts, checklists, articles, and more. Creating educational content for consumers about Roth conversions can help you establish credibility and build trust.

Another great way to incorporate Roth conversions into your marketing is by hosting a Roth conversion webinar. Show retirees how you can help address some of their key pain points. Share the benefits of Roth conversions and how you can help attendees add dollars to their retirement strategy. The value you can add will be evident.

Conclusion

Many advisors recognize that taxes can have a significant impact on their clients' retirement strategies. Alleviating some of the burdens by moving funds from a traditional retirement account into a Roth IRA addresses these challenges. You can add value to your existing clients' retirement, reach new prospects, and ultimately grow your business by considering the impact of Roth conversions on the retirement strategies you create.

Support for Roth Conversions

SMS Financial Solutions can help you offer Roth conversions to your clients.

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