3 Misconceptions About Roth IRA Conversions

Advisors shouldn't assume that these rules of thumb apply to every client.

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The answer to the Roth IRA conversion question is not always simple. Because it can be an extremely material financial decision, advisors should take care to analyze each individual situation. Learning from experts can certainly help, and advisors should consider working with clients' CPAs.

Steven Jarvis is one such expert. Jarvis is the founder of Retirement Tax Services and of a new conference taking place Sept. 27-29 in Las Vegas called the 2023 Next Level Tax Planning Summit. Jarvis says that investors and advisors have three common misconceptions about Roth IRA conversions.

1. You should not do a Roth IRA conversion if you don't have outside cash to pay taxes.

Most advisors will put up a â€œstop signâ€ on Roth conversions if the client does not have outside cash to pay tax on the conversion income. (I have to admit that I fall into that category.) According to Jarvis, however, â€œmathematically you will get more into Roth if you pay the taxes from nonqualified dollars, but getting 78% of an IRA distribution into Roth is infinitely higher than 0%.â€ So, for clients who can't pay taxes from nonqualified funds, the advisor should not automatically stop there. The decision must be based on the client's specific situation.

2. A client in the highest tax bracket should not do a Roth IRA conversion.

When a client is in the highest tax bracket, it seems counterintuitive to suggest Roth conversions. â€œThe most clear-cut instance of Roth conversions making sense in the highest bracket is for taxpayers at a level of income and wealth where they can reasonably expect to be in the highest tax brackets throughout their lives,â€ Jarvis says. â€œTax rates may rise in 2026 and are currently at historical lows. For taxpayers already in the highest bracket who expect to always be there, converting to a Roth is a way to pay the devil we know, instead of waiting to find out what the devil we don't know will look like in the future.â€ Additionally, the fact that all principal and future earnings will be forever tax-free makes a compelling argument for conversion even in a high tax bracket. Again, this decision must be based on the individual client's personal preferences and expectations for the future.

3. If the client is not in the highest tax bracket and has cash to pay the taxes, a Roth IRA conversion is always a good idea.

This might be true in general, but there are exceptions. A big exception is when the client plans to leave their IRA to charity. Why pay tax to convert to Roth when donating IRA dollars are not taxable? Using qualified charitable distributions and leaving IRA balances to charity means the charity gets 100% of the money without a tax reduction.

Despite individual circumstances that might discourage a Roth conversion, Jarvis is a big advocate for conversions in general. â€œRemoving tax uncertainty is an advantage in and of itself,â€ he says. â€œSince the tax code can change at any time [and is, in fact, scheduled to increase in 2025], a client who is concerned about the possibility of tax increases can take that uncertainty out of the equation by converting to Roth.â€

Another big advantage? According to Jarvis, a Roth conversion creates â€œtax flexibility.â€ In retirement, the client has an additional pool to draw fromâ€”one that will not generate taxes.

In addition to Jarvis, I will also be speaking at the Next Level Tax Planning Summit. My presentation will include case studies showing how high-level tax strategies can be combined to make a big difference in your clients' lives.

Morningstar readers get a discount to attend the conference: $300 off the in-person conference or $200 off the virtual conference. When registering, use the promo code: RTSPartner. For more information, contact the RTS Team at advisors@rts.tax.

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