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WEALTH MANAGEMENT INSIGHTS

Systematic Annual Roth Conversions

Schwab Center for Financial Research

Hayden Adams, CPA, CFP®
Director

Alex Haun, CFA, CAIA
Senior Research Analyst

Key Takeaways

- Roth IRAs have many desirable traits, including the potential for tax-free growth and for tax-free withdrawals, tax efficiency and flexibility in retirement, and estate planning.
- However, due to income limits, not all investors can contribute directly to Roth IRA accounts.
- As an alternative, investors can convert money held in traditional IRAs and other retirement accounts into a Roth IRA account all in one year, or in a planned way over several years.
- This disciplined, annual approach to Roth conversions, a strategy we call systematic annual Roth conversions, can increase balances in tax-free savings vehicles and reduce taxes over the long term.

Overview

Tax-exempt Roth Individual Retirement Accounts (IRAs) can be a powerful tool to help diversify savings by tax treatment and provide flexibility to manage tax brackets when taking distributions in retirement or leaving money behind tax-free to heirs. Roth account features include: tax-free growth, tax-free qualified distributions, no required minimum distributions (RMDs), and passing on assets to heirs free of taxes on distribution.

Contribution and income limitations cap the amount of assets investors can place within Roth accounts. However, regularly converting money already held in a traditional IRA or 401(k) to a Roth account, a strategy known as a Roth conversion,[1] can increase how much you can invest tax-free. Depending on your current versus future tax bracket, this could lower the taxes you pay over the long term.

Who can benefit from Roth conversions?

Generally, Roth conversions make the most sense for investors who expect to be at a higher tax bracket when withdrawing the funds in retirement. In addition, it's best to have funds available in a bank or brokerage account to pay the taxes on the conversion, to help increase the amount of money that can be transferred to the Roth account.

Finally, the longer the time horizon before you expect to make withdrawals from the Roth account, the greater the potential tax advantage. At a minimum, the assets should not be needed for at least 5 years,[2] but it's best to have an even longer time frame, potentially allowing the assets to benefit more from tax-free growth.

What are the potential benefits?

No RMDs. Any converted amounts will not be included in RMD calculations. This can be especially useful for those with large tax-deferred retirement accounts where RMDs may be larger than the amount needed to provide for living expenses in retirement.

Increased flexibility to manage tax brackets when taking distributions. Having Roth assets can offer

additional distribution options in retirement, which could be used to strategically reduce your taxes on retirement distributions.

Increased flexibility for legacy and estate planning. If you'd like to leave money to heirs, and have saved a sizable amount in retirement accounts, it may save taxes to convert retirement savings to Roth IRAs and leave Roth assets to heirs.

Pay taxes now at historically low levels. As of today, tax rates are at a historically low level compared to rates over the past few decades. If you believe taxes could rise in the future, then a Roth conversion today could help you avoid taking distributions down the road at a higher tax rate.

It's not an all-or-nothing decision. You can convert all or just a portion of your tax-deferred retirement account assets to a Roth. However, the pro rata rules may apply to a partial conversion (see below for more details).

What are the potential downsides?

Consider these issues before completing a Roth conversion:

Taxes are due in the year of conversion. You'll need to weigh the opportunity cost of using funds now to pay taxes on a Roth conversion versus paying taxes later. A Roth conversion could also impact the potential tax deductions and credits available to you. In addition, a conversion can increase taxes on Social Security benefits and how much you pay for Medicare premiums. So, it's important to meet with a tax professional to ensure that a conversion will not result in an unexpected outcome.

You can't cherry pick the after-tax contributions for conversion. If you're only converting a portion of your IRA assets and you have pre-tax and after-tax contributions in that account, the pro rata rules may apply to the conversion. The pro rata rules require you to convert both pre-tax and after-tax assets in proportion to your overall IRA account values.

You can't undo a Roth conversion. Prior to passage of the Tax Cuts and Jobs Act (TCJA) in 2017, investors could reverse - or recharacterize - a Roth conversion. The TCJA disallowed recharacterization. Once the transaction is complete, the investor cannot reverse it.

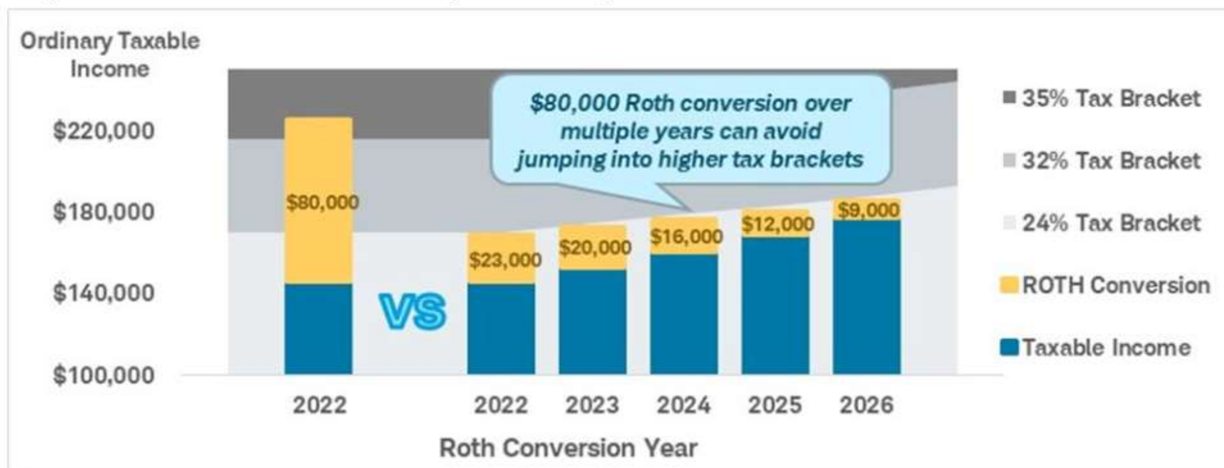
You may need to wait 5 years before accessing the Roth assets. A Roth conversion may not be a good option for investors who don't qualify for a tax-free distribution (based on the IRS rule that requires assets be held in a Roth account for 5 years before tax- and penalty-free distributions can be made).[2]

How much should an investor convert?

A Roth conversion will increase your taxable income, so how much to convert in any one year requires tax bracket management. Tax bracket management is strategically planning out the recognition of annual income in a way to lower your taxes over your lifetime.

Roth conversions completed over several years, rather than all at once, can help avoid paying taxes at a higher tax bracket. In the chart below, we see that doing a single large conversion pushes the investor into the

Large Roth Conversion in One Year Compared to Multiple Years



Source: SCFR. Assumes a $80,000 Roth conversion in a single year compared to spreading a $80,000 Roth conversion over multiple years. The example is hypothetical and shown for illustrative purposes only. Tax brackets representative of 2022 ordinary income tax brackets with future years assuming tax bracket growth of 2.5% and wage growth of 5%.

35% tax bracket. Whereas doing smaller Roth conversions over time could keep the investor in the 24% tax bracket. Work with a tax advisor to confirm your projected taxable income, tax bracket, and potential impact on your tax bill.

Case study

To see how a systematic Roth conversion plan can both avoid higher tax brackets and reduce RMDs in retirement, consider Kathy, who is a 60-year-old single investor who just retired. To maximize her Social Security benefits, Kathy wants to delay filing until age 70. Her $2 million of retirement assets are in a tax-deferred 401(k), but she would like more flexibility in retirement by having some assets in a Roth account. Before any Roth conversion, a Schwab Comprehensive Financial Plan™ would project withdrawals that look something like the illustration below.

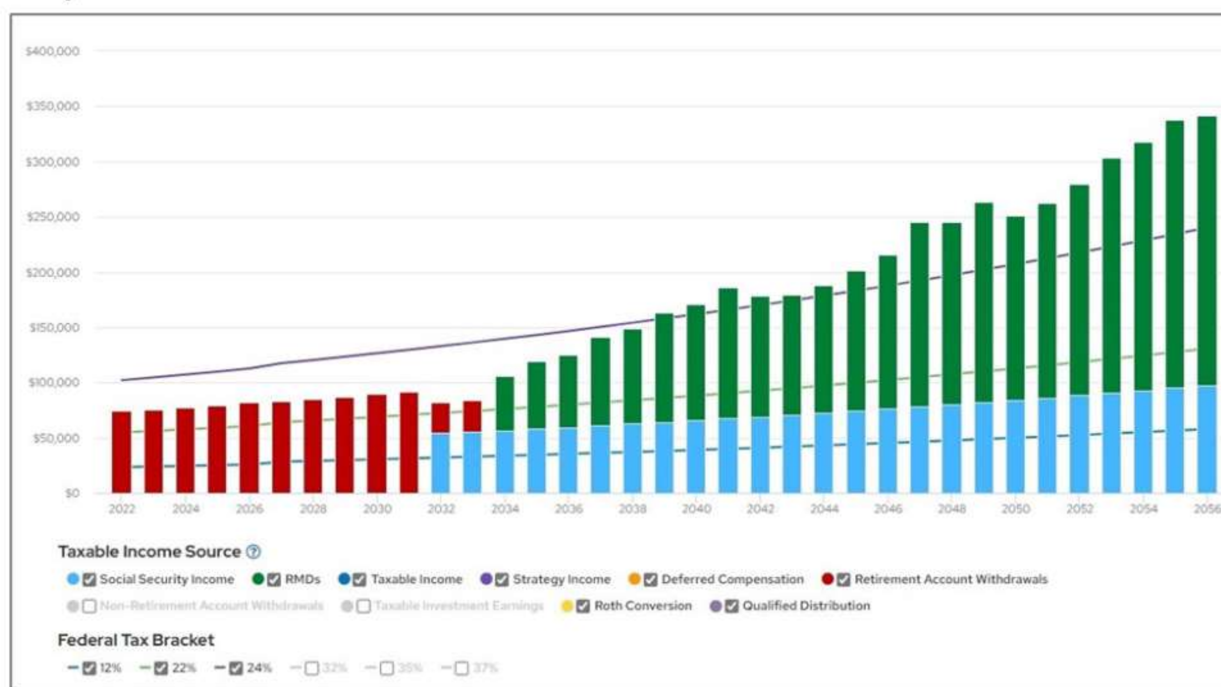
For the next 10 years, Kathy's planned withdrawals from her 401(k), most typically to support her retirement spending, will place her within the 22% tax bracket. But after she claims Social Security, within a few years, RMDs will require her to withdraw more than she needs from her 401(k) account and will push her into a higher, 24% tax bracket. Kathy can convert some of her 401(k) assets to a Roth account each year, when her plan and our projections show that she may be in a lower tax bracket until she files for Social Security at age 70 in 2032 and starts RMDs at age 72 in 2034.

> Roth conversions completed over several years, rather than all at once, can help avoid paying taxes at a higher tax bracket.

Roth conversion results

Withdrawing from a traditional IRA and depositing and converting assets into a Roth IRA each of the next 10 years to fill the 24% tax bracket, in this example, can help reduce Kathy's future taxes, increase the amount of savings she holds in a flexible, tax-free Roth IRA, and provide flexibility to withdraw without taxes or use retirement savings as part of her desire to leave some investments without future tax implications to heirs (see the illustration on page 4).

Kathy's Retirement Cashflows with No Roth Conversion



Source: SCFR, hypothetical results from Kathy's Schwab Comprehensive Plan™. This example is hypothetical and provided for illustrative purposes only. Assumes a single, 60-year-old investor with a planned 35-year retirement. Retirement expenses assumed to be $65,000 inflated at 2.5% and an initial $2 million 401(k) portfolio with no other assets, allocated to a 60% equities / 40% bonds and assumed portfolio return of 4.92%. Individual situations will vary.

These Roth conversions can also potentially reduce Kathy's RMDs in the future and reduce the number of years she'll move up above the 24% tax bracket. This ultimately leads to potential tax savings.

Bottom line

A disciplined plan converting savings from traditional IRAs or retirement accounts to a Roth IRA annually, based on your tax bracket as part of a long-term wealth management plan, can increase tax-exempt assets allowing for greater flexibility in retirement.

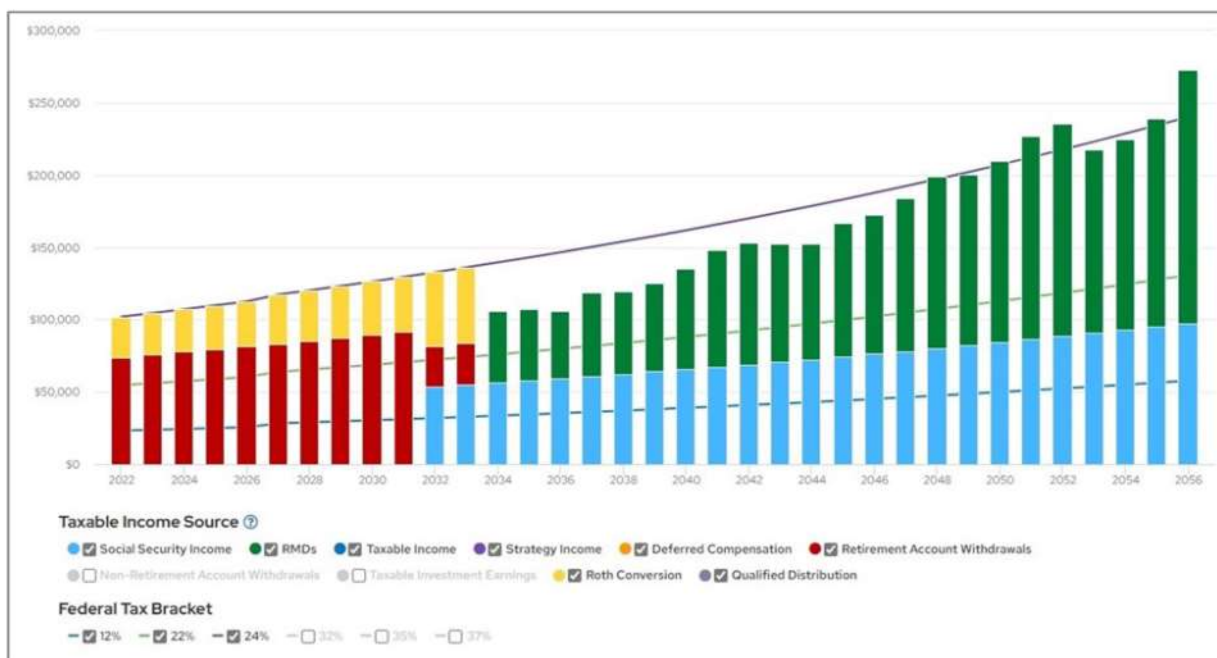
The illustrations shown in this Insight are taken from a Schwab Comprehensive Financial Plan™, using Kathy's hypothetical example. Your personalized plan would include your own investments, details, and distribution and conversion plan.

As always, work with a trained financial planner or wealth manager, in partnership if needed, with your tax preparer or advisor.

Endnotes

1. It's generally recommended to use a trustee-to-trustee transfer when completing a Roth conversion. This can be done by directing the financial institution that holds your traditional IRA to transfer the money directly to a Roth IRA account.
2. See IRS publication 590-B for details about the Roth IRA 5-year rule for contributions and the Roth conversion 5 year rule. See also IRC §408A(d)(2), §72(t), Treas. Reg. §1.408A-6.

Kathy's Retirement Cashflows with a Roth Conversion



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Hayden Adams, CPA, CFP®

As Director of Tax and Financial Planning for the Schwab Center for Financial Research, Hayden provides analysis and insights on topics including income tax planning, tax-smart investing, asset allocation, and retirement withdrawal strategies for a range of Schwab clients and advisors.

Alex Haun, CFA, CAIA

As Senior Research Analyst - Tax and Wealth Management for the Schwab Center for Financial Research, Alex provides quantitative research focused on tax-efficient investing for Schwab clients and advisors.

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Roth IRA conversions require a 5-year holding period before earnings can be withdrawn tax free and subsequent conversions will require their own 5-year holding period. In addition, earnings distributions prior to age 59½, are subject to an early withdrawal penalty. Earnings on Roth 401(k) contributions are eligible for tax-free treatment as long as the distribution occurs at least five years after the year you made your first Roth 401(k) contribution and you have reached age 59½, have become disabled, or have died.

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