

Knowledge is Power

December 2023 Question Of The Month - Big Decisions To Make

“Hello, Brian. My husband and I have saved a good amount of money for retirement. Most of it is in our pre-taxed IRAs and 401(k) retirement plans. We are concerned about tax increases in the future, so we are considering doing a Roth conversion this year. However, we are not sure we should do this. Can you provide some factors we should consider to help us in making our decision before the end-of-the-year deadline comes to make this move? Thanks so much.” Karen

Hello, Karen. You certainly are not alone in considering this option and in wondering if, how and when to do it. Just like you, the majority of people have saved for retirement in pre-taxed retirement accounts, such as traditional IRAs and 401(k)s. This means that when that money is withdrawn, it is taxed at ordinary income tax rates for that specific year. In addition, those withdrawals could force other incomes to become taxable as well, such as Social Security. Thus, with many people expecting tax rates to increase substantially in the future, distributions from these types of retirement plans could really cause a tax nightmare.

One potential solution to this is doing Roth conversions. A Roth IRA grows tax free and allows for tax-free distributions to the account owner, a surviving spouse, and beneficiaries. And one way of getting money into a Roth IRA is through Roth conversions. Of course, you must pay the taxes owed on the money when you do a conversion, but once that is done, the money is free and clear of taxes forever, including the growth on the money. So, how do you determine if you should do a Roth conversion? There are several factors to consider.

The main objective for pre-taxed retirement account money is to figure out how to pay the tax owed on that money at the lowest rate possible and/or to minimize the taxation on that money over time. So, you need to compare where you are at today (tax bracket wise) versus where you expect to be in the future. If you are in a very high tax bracket today and expect to be in a lower bracket at a later time, then you probably should not do a conversion now. If you are in a low tax bracket now, or in the lowest bracket you think you will ever be in, then you probably should convert at least enough to max out that tax bracket. Remember, taxes are owed on pre-taxed retirement account funds, so the objective becomes to determine when and how to pay the tax. Roth conversions give you the power and availability to choose when and how to do this instead of just waiting and letting Uncle Sam control the taxation of those dollars.

Now, if you decide to do Roth conversions, it may not be wise to convert all your pre-tax retirement account dollars. Why is that? Well, money that comes out of pre-taxed accounts that stays under the standard deduction, or that goes to charity, is not taxed. So, the goal would be to leave enough

in your pre-taxed accounts that you can get it out tax free.

Another thing to consider is the effect that Roth conversions could have on your Medicare premiums. The cost of Medicare premiums is dependent on certain income thresholds. If you go over these thresholds, then your Medicare premiums could go up for at least a year. So, this could be another cost to consider before doing conversions.

Finally, there are other types of tax-free accounts such as life insurance. If you are wanting to do Roth conversions to pass your money on to your heirs tax free, then life insurance or other types of tax-free plans may be a better solution.

In my opinion, becoming as tax efficient as possible is one of the biggest keys to having a successful retirement plan. Roth conversions are certainly one potential way to do this, but it is a very big decision because there are many key factors you have to consider before making this move. And you must consider this very quickly because the deadline to do a Roth conversion is by the end of the year to count for that tax year.

Join me on my radio show this weekend where we will discuss these factors in greater detail, including some case examples. We will also answer some other retirement and tax-related questions that require some big decisions to make. The show airs on Sunday morning at 8 am on WWKI (100.5 FM) or online at www.theretirementmoneymattersshow.com. You can also obtain this information by reaching out to us at Hayes Advisory Group at 452-PLAN (7526), 800-939-1603 or brian@hayesadvisorygroup.com.