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6 Reasons to Convert Traditional Retirement Accounts to a Roth IRA

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June 7, 2022 | 7 MIN READ

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A Roth IRA is one of the best retirement accounts around – and for good reason.

Experts love Roth IRAs for their tax-free income, ability to leave money to heirs tax-free, and overall financial flexibility in retirement. In 2022, you can contribute up to $6,000 to your Roth IRA if you're under 50 (or $7,000 if you're over 50), provided you're under the income limits. And if you're not, there's still a way to take advantage of this retirement account.

There are workarounds to get more funds into your Roth IRA and you can do so by converting money from other retirement accounts. It's called a Roth IRA conversion, and depending on your situation, it can give you tax-free growth, more investment options, and a way to avoid being forced to take out money when you necessarily don't want or need to.

Read on to find out if a Roth IRA conversion is right for you.

What Is a Roth IRA?

A Roth IRA is a retirement account that uses after-tax dollars to fund retirement. It grows tax-free and when you take out distributions in retirement, you don't pay taxes on those distributions. "It's a fantastic vehicle for saving," says Emily Smith, CFP®, director of financial planning at Williams Jones Wealth Management in New York.

To contribute up to the $6,000 maximum this year, your Modified Adjusted Gross Income (MAGI) must be under $144,000 for the tax year, and under $214,000 if you're married or filing jointly. If you make over those income limits, a backdoor Roth IRA is a good option for you to take advantage of the benefits of a Roth IRA.

Does a Roth IRA Conversion Make Sense for You?

It depends on what your goals are. Here are six common reasons where a Roth IRA conversion makes sense:

You think your future tax bracket will be higher. If you expect your income to keep rising, a Roth IRA conversion is a way to convert funds at your current tax rate – and then withdraw them tax-free in retirement.

You need more diversity. If you have other accounts, like a traditional IRA or 401(k), adding a Roth IRA to the mix can provide a way to manage your future income and tax brackets. Remember, Roth IRAs don't have required minimum distributions, meaning you're not forced to take out money at a certain age like other retirement accounts, so you can use the money to supplement your lifestyle without adding to your tax burden.

You want to take advantage of market dips. When the market goes down, your shares aren't worth quite as much – which creates an opportunity to convert them to your Roth IRA for less tax. Then, when the market recovers, your shares will experience tax-free growth until you're ready to sell down the road.

Your income is lower this year. If your business is having a slow year and you find yourself temporarily in a lower tax bracket, it could be the perfect time to convert funds to a Roth IRA, "because those conversion dollars are taxed at your ordinary income rate," Smith explains. This is especially true if you think your tax bracket might go back up the following year.

You want to hedge your bet that taxes will continue to rise. Lawmakers write new bills all the time. There's nothing to say that the government won't raise taxes in our lifetimes – or even change the tax rules for Roth IRAs. You can give your money more time to grow – and hopefully avoid future tax hikes by dedicating your funds early.

You want to give a tax-free gift to your heirs. Unlike other inheritances, your heirs won't pay taxes when they withdraw from a Roth IRA, so there are no tax consequences for them. Converting your funds to a Roth IRA means more of your money will go directly to your beneficiaries instead of to tax payments.

On the other hand, a Roth IRA conversion won't make much sense if you're close to retiring, would cause your taxable income to rise too much, or you don't have the cash on hand to pay the income tax upfront. In these scenarios, a conversion would likely be counterproductive to your financial plans. As always, talk with a tax professional to see if it makes sense for your situation.

PRO TIP

If you plan on being in a higher tax bracket in the future, a Roth IRA conversion can make sense because you won't pay taxes on distributions. Or, if you want to keep working, a Roth IRA helps you avoid required minimum distributions. But consider if paying income tax on the amount you convert is worth it for your future plans.

Benefits of a Roth IRA Conversion

If you can afford to pay the taxes that will be due on the Roth conversion, you can get decades of tax-free compounded growth. And if you think your tax rate will go up, you will have paid far less in taxes by doing a conversion early.

"Essentially, you're paying taxes now to avoid paying taxes in the future on a larger pool of assets," says Jill Fopiano, president & CEO at O'Brien Wealth Partners. That's a huge benefit that can both save and earn you more money.

A Roth IRA conversion can be a great estate planning strategy. If you have other taxable assets with required minimum distributions that you don't end up needing, experts say it might make sense to convert them to a Roth IRA now. "Leave those as a vehicle to your children. They continue to grow tax-free for 10 years after they've inherited them and then at year 10, they receive a tax- free distribution," Smith says.

Another benefit is that you don't have to take required minimum distributions starting at age 72 like other retirement accounts. Instead, you can let your money keep growing, or save it to pass down to your beneficiaries.

How to Convert a Traditional IRA or 401(k) to a Roth IRA

First things first, you don't need to convert entire accounts at once. You can break up your conversion into several tax years so you don't get hit with a big tax bill or push yourself into a higher tax bracket than intended.

For this reason, a Roth IRA conversion can be a good idea when your tax bracket is low early in retirement, but before you begin taking money out. You might also consider spacing out your conversions if there will be an impact to your Social Security or Medicare benefits.

To get started, you'll need to get in touch with your brokerage to perform one of the following types of conversions:

Trustee-to-trustee. This is when you ask your current IRA or 401(k) provider to send your funds to your Roth IRA provider

Same trustee transfer. If your provider is the same for both IRAs, you can simply transfer the funds between your accounts.

Indirect rollover. This is when your broker sends you a paper check, and you get 60 days to deposit it to your Roth IRA account.

"In many cases, you can go right on the [broker's] website and it will give you the route to go to make the conversion," Fopiano says. If you don't already have a Roth IRA account, you'll need to open one. Some of the best online brokers include Vanguard, Fidelity, and Charles Schwab.

When you deduct funds from your traditional IRA or 401(k), you'll need to pay taxes on the converted amount. If your account has a mix of tax-deductible and non-tax- deductible funds, you might only have to pay taxes on a percentage of your funds. Ask your financial advisor if this rule applies to you.

Most transfers are made within a week or two. Keep in mind, you'll owe tax for the year in which you make the conversion. So if it's getting toward the end of the year, give yourself plenty of transfer time if you want your conversion to count toward the current tax year.