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Conversion to a Roth IRA

Is this something to be considered early in retirement?

IRAs have become a very important element of retirement security. The Individual Retirement Account was added to the tax code in 1974, along with the ERISA overhaul of retirement plan regulation. Contributions may be deductible, depending upon the taxpayer's income, and distributions are taxable as ordinary income. The Roth IRA made its appearance in 1997. There are no deductions for contributions, but if all conditions are met, all the distributions from a Roth IRA during retirement are tax free.

As the table below shows, nearly 30% of American households have a traditional IRA, and just over 20% have a Roth IRA. However, nearly 90% of IRA assets are held in traditional IRAs, over $10 billion. The reason for the disparity is that in many cases traditional IRAs are used, through a rollover of the funds, to preserve the tax deferral for distributions from 401(k) plans and other qualified retirement plans. The contribution limits for such plans is far higher than the limits for IRAs.

The Roth conversion option

A traditional IRA may, at the option of the account owner, be converted to a Roth IRA. There are no income restrictions on who may exercise the conversion option. However, there is a price to be paid, as the entire amount of the conversion must be included in ordinary income.

For larger IRAs, that can be an intimidating tax bill. But when one works through the math, conversion to

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IRA ownership

Type of IRA	Year made available	Number of households owning	Percentage of households owning	Assets (billions of dollars, year-end 2020)
Traditional IRA	1974	36.8 million	28.6%	$10,290
Roth IRA	1997	26.3 million	20.5%	$1,210

Source: Investment Company Institute 2021 Fact Book a Roth IRA may be a very good idea, especially early in retirement. That was the conclusion of economist David Bernstein, in an essay, "The Role of Roth Conversions Early in Retirement" [Tax Notes, November 22, 2021].

The optimum conditions are that the taxpayer no longer has wage income, has not yet started Social Security benefits, and has other financial resources to draw upon to meet expenses, such as an after-tax investment portfolio. In that situation, the cost of conversion to a Roth IRA may be relatively low.

Bernstein offers the example of a taxpayer with investment income of $10,000 and no Social Security benefits. A married taxpayer filing jointly, claiming the standard deduction, could convert $14,800 to a Roth IRA at no cost whatsoever. "It would be irrational for this taxpayer to fail to convert some assets from a traditional plan to a Roth account," Bernstein writes.

Next, assume that the taxpayer converts $34,550 to the Roth IRA. That carries income to the top of the 10% tax bracket. The cost of such a conversion would come to $1,975, which seems a small price to pay compared to the potential for tax-free income.

As one moves up the income brackets, either because the base income is higher than $10,000 or the amount converted gets larger, the tax bill may begin to seem less like a bargain.

Big benefits

There are three benefits offered by the Roth IRA to take into account.

Planning flexibility. Minimum annual distributions are required from traditional IRAs once the owner reaches age 72. There are no such requirements for Roth IRAs. The required minimum distributions are not large in the early years on a percentage basis, but the only way to avoid them is to arrange for a distribution to charity (limited to $100,000 per year).

Tax freedom. After five years, distributions from the Roth IRA are not included in income. The income taxes have effectively been prepaid.

Lower taxes on Social Security benefits. Those required minimum distributions from traditional IRAs may have the side effect of increasing the taxes the retiree must pay on Social Security benefits received. Singles with adjusted gross incomes below $25,000 and married couples below $32,000 do not have to worry about taxes on benefits. For singles with AGI from $25,000 to $34,000, up to 50% of their benefits will be taxed, and above $34,000, up to 85% will be taxed. For married couples, the 50% inclusion bracket is $32,000 to $44,000, and 85% above $44,000.

Unlike many other elements of the tax code, these boundaries have never been adjusted for inflation. Thus, more and more Social Security benefits are being subject to income taxation as the years go by.

Tax savings

Mr. Bernstein offers this example. A couple has $40,000 in combined Social Security benefits and $3,000 of investment income. If they were to take a $50,000 distribution from a traditional IRA, the tax cost would be $7,072. If instead they could take $39,000 from a Roth IRA and $11,000 from a traditional IRA, they would pay about $400 in tax.

A household in the 22% tax bracket that can distribute $50,000 from a Roth IRA instead of a traditional IRA will save about $11,000 in taxes, Bernstein reports.

What is best for you?

Conversion of a traditional IRA to a Roth IRA is a major life decision, definitely worth paying for professional advice before undertaking. The decision must be put into the context of the taxpayer's total resources and wealth management objectives.

The tax consequences of a conversion may be softened by doing partial conversions over time. It's not an all-or-nothing decision. The conversion might be handled at 20% per year for five years, for example. Or a larger share might be converted in a year when one's income is low, putting the transaction in a lower tax bracket.

We can be of service

Helping retirees manage their retirement income is among our core services. We manage investment portfolios as well as large IRAs and Roth IRAs. Looking for lifetime financial security? Call upon our professionals soon for a consultation. ☐

State variations

In March 2021, National Vital Statistics released a longevity report that, for the first time, broke out the data by state. There is a wider variation than one might assume. The overall average life expectancy at birth in the United States is 78.7 years—76.2 for the men, 81.2 for the women. Hawaiian residents have the greatest average life expectancy, at 81.0 years. The shortest is West Virginia, at 74.4, some 6.6 years less. No explanation for the variance is offered, these are just the observed numbers.

On average, women live five years longer than men, but again there is some variability. In New Mexico, women live 6.2 years longer, and in Utah they only have a 3.8-year advantage.

For those who are entering retirement, the important question is for how many years must they plan? Interestingly, the gap among the states narrows as the population ages, and the state ranking changes. At age 65, a Hawaiian may expect to live to age 86.1, while for a Kentucky resident the average is 82.5, a difference of 3.6 years.

The table at right shows the life expectancy at age 65 for every state and the District of Columbia. However, the data is from 2018, before the COVID-19 pandemic, so the rankings today might be influenced by recent events. Still, to retire at age 65, a person needs to plan to have sufficient financial resources for at least 20 years. □

Life expectancy at age 65, by state

State	Rank	Life expectancy
Hawaii	1	21.1
California	2	20.3
Connecticut	3	20.3
New York	4	20.2
Colorado	5	20.0
Minnesota	6	20.0
Florida	7	19.9
Massachusetts	8	19.9
New Jersey	9	19.9
Washington	10	19.8
Vermont	11	19.8
South Dakota	12	19.7
North Dakota	13	19.7
Oregon	14	19.7
Arizona	15	19.6
District of Columbia	16	19.6
Rhode Island	17	19.5
Utah	18	19.5
United States		19.5
Montana	19	19.5
New Mexico	20	19.5
New Hampshire	21	19.5
Wisconsin	22	19.5
Maryland	23	19.4
Illinois	24	19.4
Idaho	25	19.3
Iowa	26	19.3
Virginia	27	19.3
Nebraska	28	19.3
Alaska	29	19.2
Delaware	30	19.2
Maine	31	19.1
Pennsylvania	32	19.1
Wyoming	33	19.0
Michigan	34	18.9
Texas	35	18.9
Kansas	36	18.8
Nevada	37	18.7
North Carolina	38	18.7
South Carolina	39	18.6
Missouri	40	18.4
Ohio	41	18.4
Georgia	42	18.4
Indiana	43	18.3
Louisiana	44	17.9
Tennessee	45	17.9
Arkansas	46	17.9
Oklahoma	47	17.6
West Virginia	48	17.6
Alabama	49	17.6
Mississippi	50	17.5
Kentucky	51	17.5

Source: National Vital Statistics Reports, Vol. 70, No. 1, March 11, 2021

Taxes on home sales

The boom in housing prices last year was welcomed by sellers, but there could be tax consequences. The tax blow for the sale of a principal residence may be softened, even eliminated, by the $250,000 exclusion from income ($500,000 for marrieds filing jointly) for the gain from the sale of a principal residence. These boundaries were set in 1997 and never adjusted for inflation. With the higher prices for some homes in 2021, the exclusion may not fully protect the capital gain from tax.

Long-term owners

To be eligible for the full exclusion for a home sale, one must have owned and used the property as a personal residence for at least two of the preceding five years. Short absences (such as vacations) are not a problem, but a prolonged absence could be.

The doubled exclusion of $500,000 for married couples is available if: (1) either spouse meets the two-year ownership test; (2) both spouses meet the two-year use test, and (3) neither spouse has claimed the exclusion within the prior two years. If one spouse is ineligible, the other may still claim up to $250,000.

Relief for short-term owners

If the two-year test can't be met, a partial exclusion may be salvaged if the home sale came about due to a change in the place of employment, a change in health or for "unforeseen circumstances." The IRS has provided examples that meet these vague requirements. For example, the exclusion would be available for a sale due to:

- multiple births from a single pregnancy;
- a lost job;
- a change in circumstances that leads to an inability to meet mortgage payments;
- development of a disease, illness or injury (selling to improve one's general health would not qualify).

For some taxpayers, a partial exclusion will be as good as a full one if it covers the full amount of their gain.

Good records are essential

These rules make good recordkeeping more important than ever. Good records for current home owners will also be important when:

- the owners intend to stay in the home for a long period of time;
- they have invested heavily in renovations;
- there is a possibility that the owners will claim a depreciation deduction for a home office or rental use of the residence. Gain will have to be recognized to the extent of any depreciation deduction claimed.

The tax on the sale of a home applies to the net after the tax basis is subtracted from the sales proceeds. Basis includes what the taxpayer paid for the house plus major remodeling, such as a kitchen upgrade or a new roof. Routine repairs don't count. Details on allowable expenses are provided in IRS Publication 523. ☐