Tax-Savvy Roth IRA Conversions

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Before you convert your traditional IRA to a Roth IRA, consider two tax-savvy strategies.

The benefits of a Roth IRA are clear—the potential for tax-free growth and tax-free withdrawals for you and your heirs.[1]

But not everyone may be able to contribute to a Roth IRA because of IRS-imposed income restrictions on contributions. But anyone can convert existing money in a traditional IRA or other tax-deferred retirement savings account to a Roth IRA. And many do. In fact, Roth IRA conversions at Fidelity are up 24% from last year.

A Roth IRA conversion does have a cost. You need to be prepared to pay income taxes on the amount you convert. You "front-load" the taxes. But, by doing this, you give that money the potential to grow tax free and ensure that you have tax-free withdrawals for you and your heirs.

Here are two ways to help you manage that tax hit. One even lets you do some good by combining the conversion with a charitable deduction.

Spread the cost

A common way to manage taxes on a Roth IRA conversion is to spread the conversion over a few years. This will allow you to spread the tax bill too, and it may also prevent the income from the conversion from bumping you into a higher tax bracket.

Consider this hypothetical example: Imagine a married couple, the Mullens, who expect to file jointly with $100,000 in taxable income. They could convert up to $50,000 to a Roth IRA and stay within their current tax bracket (which for this example is taxable income between $90,000 and $150,000). As long as their tax rate and income generally stay the same, they could convert this amount yearly until they reach the total amount they want to convert. The potential benefit is that they maintain a consistent tax rate when converting (provided their situation or the tax rates don't change in the ensuing years). If they converted more than $50,000, any amount over the current marginal rate income range would be taxed at the next higher marginal rate. Things aren't always as simple, however, as they are in this example. For higher-income filers, for instance, phaseouts on itemized deductions and personal exemptions can make computing taxable income more complex.

Managing the tax impact of a Roth IRA conversion requires careful analysis. Ideally, you should include it as part of a review with a financial or tax adviser.

Other things to consider

Your conversion must be completed by December 31. Estimating your taxable income may be tricky until you've received all your tax reporting documents, which typically aren't available until well after December 31. So your income may end up being higher or lower than you expected.

A solution: a recharacterization. It allows you to "undo" some, or all, of a conversion made the prior year. You typically have until October 15 of the year following conversion to recharacterize.[2] For example, say after they converted $50,000 to a Roth IRA, the Mullens discover in January of the following year that their income was higher than they expected. Because of that, $10,000 of the conversion ended up being taxed at a higher rate instead of their current one. They could recharacterize that $10,000 to bring their total taxable income back into their current bracket. Some recharacterizations save more than others, and because they do involve paperwork, it's a good idea to do the math and make an informed decision. For the Mullens, recharacterization (followed by another conversion in a later year, when their income is lower) would save $500 if the tax rate to which they'll be subject on the $10,000 is five percentage points higher than their current bracket.

Another challenge: If you're near the top of your bracket, it may take a long time to convert the total amount that you want without moving into a higher bracket. For instance, if you file jointly and your taxable income is $100,000 and the next bracket begins at $110,000, you could convert only $10,000 if you wanted to stay within the same bracket.

Make a charitable contribution

Tax deductions can help offset the tax cost of a Roth IRA conversion and perhaps allow you to convert a larger amount at a lower tax cost. Among the more flexible of deductions, especially for high-income earners, are charitable contributions.

The tax deduction for a contribution to a public charity can be up to 50% of your adjusted gross income (AGI) for cash donations and up to 30% for donations of securities (generally deductible at fair market value when long-term appreciated securities are gifted) in a given year. And if your contribution exceeds these limits, the excess can generally be carried forward for up to five years. (Note: These limits are generally applicable, but there are exceptions, and the rules are complex. Consult a tax adviser when considering a large charitable contribution.)

To estimate the amount of the charitable deduction you may be able to claim, you generally add the taxable portions of your conversion amount to your AGI. For example, if you are planning to convert $200,000 to a Roth IRA and expect your AGI before the conversion to be $150,000, your estimated AGI would be $350,000 after the conversion. You could potentially deduct up to $175,000 (50% of $350,000) of a charitable cash contribution or $105,000 (30% of AGI) of a charitable donation of securities with long-term appreciation, which could significantly reduce the tax impact of a conversion.[3]

An example

A charitable donation may help reduce the tax cost of a Roth conversion.

Roth IRA conversion	Charitable donation	Taxes due to IRS
$100,000	$0	**$40,000**
$100,000	$100,000	**$0**

Gifts to charity are irrevocable and nonrefundable. This is a simplified hypothetical example for illustrative purposes only. Tax results can vary greatly depending on an individual's tax situation. Other strategies may provide more flexibility and similar savings, including utilizing other deductions and/or converting your assets to a Roth account over several years. Please consult your tax adviser.

Consider this hypothetical example (shown right): Richard and Ellen Nettle are considering a large Roth IRA conversion. They have $500,000 in an eligible rollover IRA and $500,000 in a taxable brokerage account—which could be used to pay the taxes on the conversion, or to make a charitable donation. The couple expects that in the coming years their income will be higher, pushing them into a higher tax bracket, so they'd like to convert $100,000 from their rollover IRA at the lowest possible tax cost as soon as possible. The Nettles regularly give to charity and could make a $100,000 one-time gift to charity this year from their taxable brokerage account. The couple expects $300,000 in AGI this year. If they made a charitable contribution of $100,000 of securities from their taxable brokerage account, they could deduct it from their income. The Nettles' combined federal and state/local income tax rate of 40% would apply to the $100,000 Roth conversion, so it would cost them $40,000, which they could offset entirely with their $100,000 contribution.

So the Nettles could save $40,000 in taxes if they make a charitable donation the same year they convert. However, they would need to be able to afford the $100,000 charitable donation—an important consideration. On the other hand, if the $100,000 that the Nettles gave to charity included securities with long-term appreciation, by gifting the securities, the Nettles also avoid taxes on the realization of those gains.[4] In some cases that can significantly reduce the effective after-tax cost of a charitable contribution.

This is a simplified example. Phase-outs of itemized deductions can change the calculations, as well as limitations on charitable deductions based on the type of charity. For these reasons, it's important to speak with a tax adviser as part of a Roth IRA conversion decision.

Consider a donor-advised fund

What if you prefer giving regularly rather than making a single large gift to charity when you convert to a Roth IRA? You may want to consider a donor-advised fund, or DAF. DAFs, which are programs offered by public charities, allow you to make a charitable contribution in a given year, and take a tax deduction for that year. Then, at a later time, you can recommend grants from your DAF to the charities you wish to support. You could take a tax deduction in the year you do a Roth conversion to help offset the conversion taxes and still continue supporting charities over several years. With a DAF, you front-load a "ready reserve" of charitable dollars that can be used over time to support many charitable causes.

Some challenges to the charitable-offset strategy: Gifts to charity are irrevocable. Unlike Roth conversions, which can be "undone," or recharacterized, gifts to a charitable organization, including DAFs, are final. So if you decide to recharacterize, you would need to determine how much of your charitable donation was deductible for that year and how much may need to be carried forward to other years. It also might be at a lower tax bracket than you expected. Also, charitable deductions may be worth more if taxes go up in the future, because they may be deducted against a higher tax rate.

Conclusion

Managing the tax impact of a Roth IRA conversion requires careful analysis. Ideally, you should include it as part of a review with a financial or tax adviser to fully investigate whether you're likely to benefit from a Roth IRA conversion and how to execute it appropriately.

1. A distribution from a Roth IRA is tax free and penalty free provided that the five-year aging requirement has been satisfied and at least one of the following conditions is met: you reach age 59½, die, become disabled, or make a qualified first-time home purchase.

2. To be eligible to recharacterize, you must file your taxes or an extension by the April 15 deadline.

3. This does not take into account any limitations on itemized deductions or personal exemptions for taxpayers in higher tax brackets.

4. The 50% limit on cash contributions and 30% limit on security contributions to 501(c)(3) public charities is an aggregate limit as a percentage of a taxpayer's adjusted gross income (AGI). Gifts to charity are irrevocable and nonrefundable.

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