Advanced Roth IRA Conversion Strategies

With the ever-changing landscape of taxes, it is growing increasingly difficult to understand how legislation affects clients and could possibly impact their financial future. As a leader in the financial services industry for the past 30 years, we get it. That's why HD Vest Financial Services® is constantly seeking ways to share the latest knowledge we acquire with you. We've created the Taxes & Investments: Timely and Timeless Strategies Series to share timely information and provide our Advisors and their clients with practical information and ideas they can build on.

With recent tax changes, high income individuals are looking for a tax-free income alternative in retirement. Unlike most retirement accounts, Roth IRAs feature withdrawals that are free from federal income taxes. All tax-deferred IRAs, including Traditional, Rollover, SIMPLE, SEP, and SAR-SEP IRAs, are eligible for a Roth IRA conversion. This was also extended to 401(k) and 403(b) assets, but those plans are not required to offer this option.

Converting to a Roth IRA is a taxable event. Federal income taxes are due on the value of pre-tax contributions and any earnings[1]. However, despite the possible tax consequences, there are several advanced Roth IRA conversion strategies that high net worth individuals should consider:

1. **Make non-deductible Traditional IRA contributions to convert to a Roth IRA.**

   Taxpayers are subject to phase outs for Roth IRA contributions. When an individual exceeds this limit there is an opportunity to make a non-deductible contribution to a Traditional IRA and then convert those contributions to a Roth IRA. Any individual with earned income is eligible to make a Traditional IRA contribution; however, it may or may not be deductible[1].

   If an individual has an already existing Traditional, Rollover, SIMPLE, SEP, and/or SAR-SEP IRA, a pro-rata calculation will have to be used to determine how much of the conversion will be taxable. You cannot choose to only convert the non-deductible balance of an IRA[1]. Also, the IRA balances must be aggregated for the calculation, meaning you cannot open a new Traditional IRA, make a non-deductible contribution and then convert based solely on that one account's balances if you have several different IRA accounts. All Traditional, Rollover, SIMPLE, SEP, and/or SAR-SEP IRAs must be added together for the pro-rata calculation[1].

   This is a great strategy for individuals who can afford to pay the taxes to convert or for individuals who do not have existing IRA balances, but are above the phase out limits. By converting, a taxpayer can diversify their income stream in retirement.

2. **Small business owners can use Net Operating Losses to cover the tax due on a Roth IRA conversion.**

   Small-business owners carrying forward large net operating losses can use those losses to offset the additional income from a Roth IRA conversion. There is no limit to how much of a net operating loss can be used to offset ordinary income[2]. Because of this, individuals may be able to convert to Roth IRAs without paying any additional taxes. The rules on calculating and utilizing net operating losses are very complicated, so it is critical for clients to consult with their HD Vest tax professional before trying to implement this strategy.

3. **Time charitable contributions with Roth IRA conversions.**

   Charitably inclined taxpayers who make significant charitable contributions are limited to how much of a tax deduction they can claim based on several factors. Of all the factors considered, the individual's income level is most relevant. Gifts of up to a maximum of 50% of an individual's adjusted gross income can be deducted in any one tax year, but that limit could be significantly lower depending on the type of gift (i.e., cash, stock, property) and the type of charity receiving it (i.e. one that benefits the general public versus one with a limited purpose)[3]. If the gift exceeds the limit, the taxpayer could be forced to carry over a tax deduction for charitable contribution into future tax years, limited to five years. If an individual plans to make a large charitable contribution, a Roth IRA conversion increases adjusted gross income and thereby could allow an individual to use up their full charitable deduction in one year.

When implemented correctly, these strategies could not only save an individual tax liability in the year executed, but also well into their retirement years. Roth IRAs allow for a diversified income stream in retirement, and thus are very attractive to high income individuals. The strategies listed all involve careful tax planning, so it is important to seek the advice of your HD Vest tax professional before using any of these plans.

Sources:

[1]IRS Publication 590, "Individual Retirement Arrangements (IRAs)," http://www.irs.gov/publications/p590/
[2]IRS Publication 536, "Net Operating Losses for Individuals, Estates and Trusts." http://www.irs.gov/pub/irs-pdf/p536.pdf
[3]IRS Publication 526, "Charitable Contributions," http://www.irs.gov/pub/irs-pdf/p526.pdf