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Opinion: Roth IRA conversions: Take advantage of this limited-time offer to save on your tax hit

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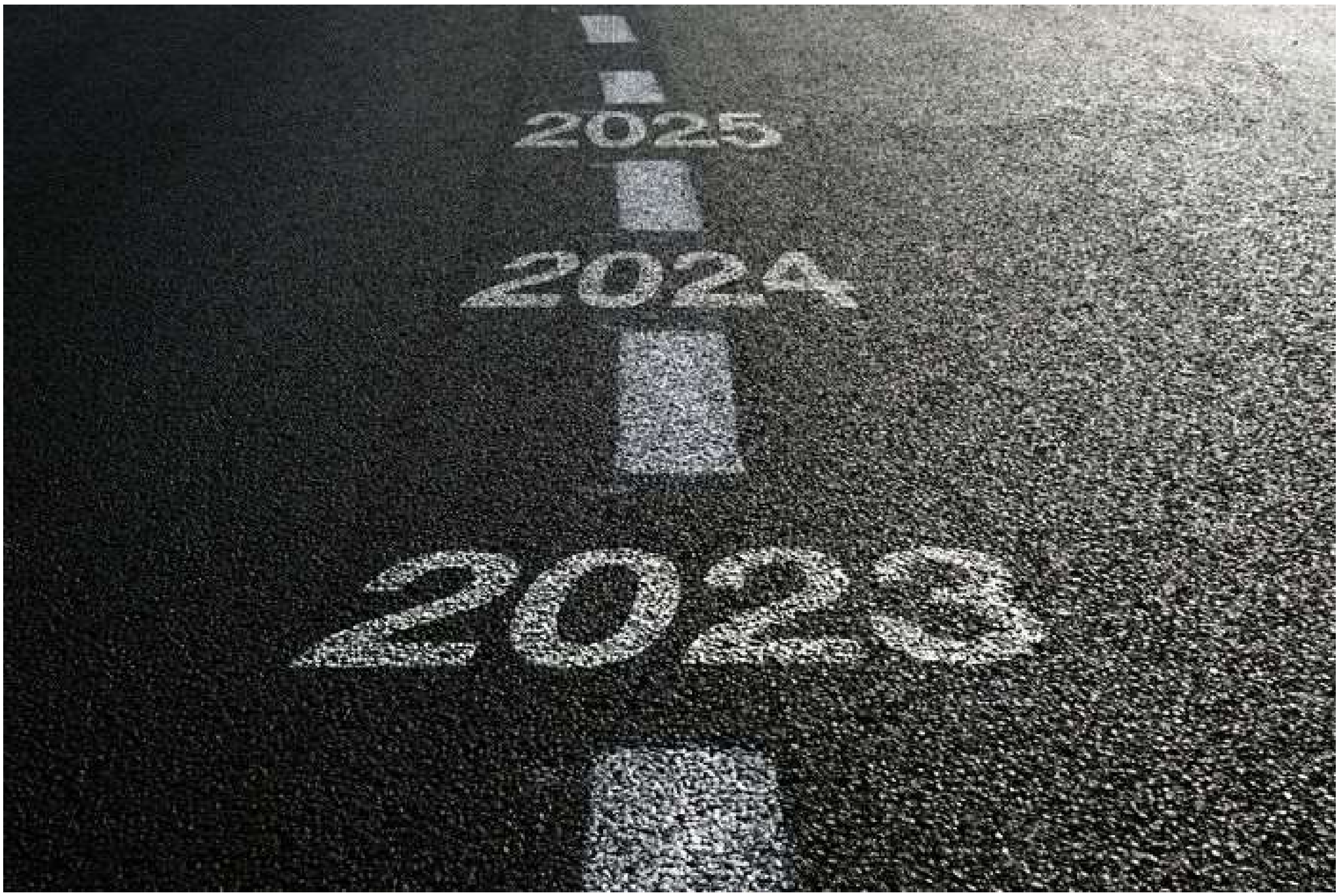
Market conditions are perfect right now to pay tax on some of your retirement funds and avoid a bigger hit later



If you expect your tax rates will be higher in the future, you may want to consider converting money now from an IRA into a Roth.
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SPX -1.12%

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No one likes taxes, but everyone loves a sale. So the idea of a major blowout on Roth conversions in 2023 — a limited time offer, no less — might make it enticing to pay taxes now to avoid them in the future.

There's a number of conditions making this year so ripe for Roth conversions, which is when you move money from a tax-deferred IRA and pay tax on the amount, and then move it to a Roth, where it grows tax-free. The major plus: Stock and bond markets are still down significantly from a year ago — the S&P 500 **SPX, -1.12%** was down more than 18% at the start of the year. That means you'll owe less in taxes when you sell investments from your IRA and then you'll buy at a discount when you reinvest in the Roth.

"Everyone likes a discount — and the tax isn't due until April of 2024," says financial adviser Matthew Carbray, managing partner at Ridgeline Financial Partners in Avon, Conn.

New tax brackets also go into effect in 2023 because of inflation, making it possible to convert more without tipping the scales into a higher tax bracket. You can now earn up to $95,375 for a single, and $190,750 for a couple and still stay in the 22% tax bracket.

"There's an unprecedented opportunity to get in on these low brackets," says Ed Slott, founder of IRAHelp.com and a longtime proponent of Roth conversions.

There's more. Overall, the tax rate environment now is considered low, but tax rates are set to rise again after 2025 unless there's more Congressional action. So that means this year plus the next two are prime time to set up a multiyear conversion strategy, Slott says.

"The whole key to good tax planning is to get money out of IRAs at the lowest possible rates," says Slott, "So I'll put the pedal to the metal in 2023. Let's hit it while it's here, because the party is ending soon."

How to get started

The key to deciding on a Roth conversion is if you think your tax rates will be higher in the future, and if you have the money to pay the tax on the conversion.

If you're young and still working, that's not going to be you. But you can think ahead and consider Roth IRA and Roth 401(k) options for your current contributions instead of trying to sort out the issue when you're retired.

The sweet spot is if you're over 59 1/2 but not yet subject to required minimum distributions from tax-deferred retirement accounts. It also helps either to be retired, so your income is low, or to be enough of a high-earner than you have money for the tax bill. Starting in 2023, the RMD age moves to 73, and then in 10 years, it'll be 75. That gives you a dozen-plus years to move your money around to your best advantage.

'It's all about the tax rates. If you believe your rates will be higher, then the Roth will win out.'

"It's a big, giant bet," Slott says. "It's all about the tax rates. If you believe your rates will be higher, then the Roth will win out."

Most people think their tax rates will be lower in retirement, but Slott and many other advisers actually see the opposite most often. Slott also notes that people tend to have fewer deductions in retirement — they are no longer contributing to IRAs, for one thing, and some might not even have mortgages anymore for interest deductions — so they end up paying more in taxes.

Most people stop Roth conversions once they start RMDs because it gets expensive. You have to take out the required amount first and pay tax on that, and then pay the taxes on the conversion, too.

But there are scenarios where you can make this work. And if you can afford it, it's a great benefit to your heirs, because they will inherit a tax-free account for 10 years (after that, they need to move it to an account where the growth will be taxed). Inherited traditional IRAs, on the other hand, are subject to taxable required minimum distributions over that 10-year time period.

Kenneth Waltzer, a financial planner based in Los Angeles, has had clients do this and it has worked out well for them. "If your RMD is something like $50,000 and you say, 'I'm taking money out anyway, so why don't I take out $150,000 and do a Roth conversion on the rest.' Then you use $50,000 to pay the tax and if you do it a few years in a row, you've shrunk the IRA quite a bit."

Roth conversions aren't for everyone

If you're not worried about leaving behind your retirement accounts and just plan on spending down your money, there's no reason to consider a Roth conversion.

Another reason to shy away is that your income level in retirement also impacts the taxability of your Social Security and your Medicare premium payments. So if you make a large conversion, you could end up increasing your overall costs.

You'll definitely want to decline if you don't have the cash on hand to pay the tax, because most people wouldn't benefit from converting more just to cover the tax due.

"Nobody should go broke converting," says Slott.

To that end, make sure to do an accurate accounting of what it will cost, and keep track of the transactions involved. You're no longer able to undo a Roth conversion, so as soon as you take the money out of your IRA, you'll owe the tax.

Slott also says to beware of trying to time a volatile market to put through your transaction on a down market day. The way things have been going, the market can swing hundreds of points within a day. The timing is only key for 2023 on a general level — tax rates and stock values are low — not down to the day or minute for a sale.

Slott has seen this in action, and it comes out badly. He had a client who asked him if she should convert that day because of the market's conditions, and he said, yes, but that only goes for right now. She tried to put the order in, but by the time it was filled, the market had gone up 800 points and her transaction cost her much more than she thought. "Timing the markets for Roth conversions is not as doable as it sounds," Slott says.

Got a question about the mechanics of investing, how it fits into your overall financial plan and what strategies can help you make the most out of your money? You can write me at beth.pinsker@marketwatch.com.

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