

Utilize a Systematic Roth IRA Conversion to Lower Your Tax Liability

Limit the amount of taxes paid when planning for your retirement!

Many investors may overlook maximizing their marginal tax brackets annually, potentially missing out on tax savings and affecting their long-term financial outcomes. Proactive tax management should be an annual discussion with your fee-only fiduciary advisor to ensure your tax liability is as small as possible and your hard-earned dollars can continue to grow.

How a Roth IRA can help you!

All contributions to a Roth IRA are funded with after-tax dollars, which means qualified Roth IRA withdrawals may be free from federal income tax if applicable IRS requirements are satisfied. Investors must follow these 2 rules in order to avoid paying the 10% early withdrawal penalty and any taxes on the funds in their Roth IRA.

1. The 5-Year Rule:

Contributions: You must wait at least 5 years from when the account was initially funded to withdraw any earnings from your Roth IRA.

Conversions: You must wait at least 5 years from when a Roth conversion occurs to withdraw any converted funds.

2. The withdrawal must take place after age 59 ½, except for other qualifying exceptions.

Unlike a Traditional IRA, there are no required minimum distributions (RMDs) for Roth IRAs. This allows for greater flexibility in deciding when to withdraw/convert pre-tax funds.

There are no income limits on Roth IRA conversions. This allows investors of any income level to take advantage of this tax-mitigation technique. Depending on an investor's circumstances, Roth conversions may be one of several tax-planning strategies worth evaluating.

Considerations When Evaluating Roth Conversion Timing

If conversions are made strategically, your overall tax liability can be controlled and mitigated. By utilizing your current (lower) marginal tax bracket and postponing the remaining amount for future distributions, investors can pay a lower total tax in their lifetime. For many, Roth conversions may improve long-term tax efficiency, depending on future tax rates, investment performance, and individual circumstances

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Details to note:

10-year rule: Requires non-spouse IRA & Roth IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31st on the 10-year anniversary of the owner's death (If the death occurred in 2020 or later). This is also a good idea if your beneficiary's marginal tax rate is higher than yours! Consult with a financial professional before making any decision.

Be mindful making Roth conversions close to filing for Medicare and Social Security. These costs are calculated based on the prior 2 years of adjusted gross income. An inflated AGI during these years would result in higher Medicare premiums and increased taxation on your Social Security benefits.

Pay the tax bill with cash from outside the Roth IRA if possible. If funds are removed from the account in order to pay the conversion tax, earning power is limited as compound interest is not allowed to function most effectively.

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Roth IRA conversions generally create taxable income in the year of conversion and may increase your current tax liability. The potential benefits and drawbacks of a Roth conversion depend on numerous factors, including current and future tax rates, income levels, investment objectives, time horizon, Medicare premium considerations, Social Security taxation, state tax consequences, and estate-planning goals. Because future tax laws and tax rates are unknown, a Roth conversion may not be beneficial for all investors and could result in higher lifetime taxes in certain circumstances. The information presented is for educational and illustrative purposes only and should not be construed as individualized tax, legal, or investment advice. Before implementing a Roth conversion strategy, investors should consult with their tax professional, attorney, financial advisor, or other qualified professionals regarding their specific situation.

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