(UBS)

Roth conversions to defuse your "tax bomb"

15 November 2024, 6:00 pm CET, written by UBS Editorial Team US Editorial Team

When you make a pretax contribution to a Traditional IRA or 401(k) retirement account, it helps you to reduce your income tax burden for that tax year. This is good in high-income years because it helps you keep income out of the higher income brackets. Your contributions will grow on a tax-deferred basis, but will be taxed when you take a distribution or implement a Roth conversion.

When you make a contribution to a Roth retirement account, your contributions will be made on an after-tax basis, but your Roth retirement account balance will generally grow income tax-free from that point and your retirement distributions will generally be income tax-free, which can help you fund your spending while staying out of higher income tax brackets.[1] Roth contributions are a good strategy for low-income years, during which you have access to lower income tax brackets and you can stay out of high income tax brackets.

There is a limit on how much you can *contribute* to Roth accounts each year (see our **Savings waterfall worksheet** for details), but there is no limit on the amount of tax-deferred assets that you can *convert* to Roth each year.

Defusing your "tax bomb"
Roth conversions are typically most valuable during your early retirement years. To understand why, let's consider how many families save for retirement.

During your working years, contributing pretax dollars to a Traditional IRA or 401(k) is usually a good strategy. After all, pretax contributions lower your income taxes and increases the amount you can save in retirement accounts, where your investments can grow tax-deferred. However, as your tax-deferred accounts grow, so does your future income tax burden. If you only (or mostly) contribute to Traditional IRA and 401(k) accounts in your working years, you may be creating a "tax bomb" for your retirement, as you will eventually have to pay income taxes on withdrawals from these accounts, either when you need the funds for spending or when the government requires you to begin taking Required Minimum Distributions (RMDs).

Roth conversions offer a valuable way to defuse this "tax time bomb" in your early retirement years. A Roth conversion involves transferring funds from your pretax Traditional IRA or 401(k) into a Roth IRA or 401(k). You will need to pay income taxes on the converted pretax amounts—including both contributions and earnings—but your Roth account investments will grow tax-free from that point, and your smaller Traditional IRA/401(k) balance will mean less taxable income from future RMDs.

By implementing a series of small partial Roth conversions— especially in your early retirement years, when Social Security income and RMDs aren't pushing you into a higher tax bracket—you may be able to pay a lower income tax rate in retirement than you would have paid in your working years, thus boosting your after-tax wealth. If you plan to leave IRA assets to your children, Roth conversions may also help to reduce the tax burden that they will face, too.

Protecting against higher taxes
In addition to helping you stay out of a higher income tax bracket in the future, Roth conversions can also protect you and your family against the risk that income tax rates themselves will go higher in the future. Higher taxes seem likely—especially for high income Americans—as a part of the solution for addressing the US governments high debt levels.

In fact, income taxes are poised to go higher starting in 2026—with higher tax rates, shifting tax brackets, and a 40% drop in the standard deduction—unless Congress can agree to extend the 2017 Tax Cuts and Jobs Act's personal income tax provisions next year. If the tax cuts do expire, families could gain an extra benefit implementing partial Roth conversions in the lower tax rates available in the 2024 and 2025 tax years.

Conclusion and next steps
Speak with your financial advisor and tax advisor to determine whether this is a good year to implement a partial Roth conversion, and whether it's a good idea to add a series of small partial Roth conversions to your financial plan. We often find that small Roth conversions, over a number of years—especially in early retirement—can boost a family's after-tax wealth by around 10-15%.

For more, see **Roth conversions to defuse your "tax bomb"**, 11 November, 2024.

Important note: Tax strategies can be complex. In addition to federal taxes imposed on ordinary income and capital gains, there may be state and local taxes that must be considered before implementing Roth conversion. Also, transaction costs that may apply from buying and selling securities need to be carefully considered. Each investor should consult his or her own tax advisor concerning the tax consequences of any investment strategy they make or are contemplating. UBS does not offer tax advice. Please note that this is not a recommendation to roll over or transfer your retirement assets. We strongly suggest speaking with a financial advisor and tax advisor to determine the best approach for your personal financial situation.

[1]You cannot withdraw earnings from your Roth retirement accounts on a tax-free basis until at least five years after your first contribution to a Roth IRA account. The clock starts ticking on 1 January of the tax year when the first contribution was made. Failure to follow the five-year rule can result in paying income taxes and a 10% penalty on any earnings that are withdrawn. Please also note that if you withdraw funds from a retirement account before age 59 ½, the funds may be subject to a 10% tax for an early distribution.