

Navigating the Complexities of Converting a Traditional IRA to a Roth IRA



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Converting a traditional IRA to a Roth IRA can be a significant decision that involves careful consideration of various factors.

In this article we'll explore these aspects and discuss the advantages and disadvantages of a conversion.

Financial Factors

There are a number of financial factors you should consider with your tax and legal counsel when contemplating a conversion.

Tax Implications: Converting a traditional IRA to a Roth IRA involves paying taxes on the converted amount up front. Ideally those taxes should be paid from money outside of the IRA, which can be a significant financial burden, especially if the conversion pushes you into a higher tax bracket. Paying the tax from the converted money might not be as burdensome, but the benefit of conversion—tax-free growth of the Roth account—can be offset to a significant degree by the tax you pay, since less money is in the Roth IRA to grow. Once converted, the Roth IRA offers tax-free withdrawals in retirement (subject to certain timing or age limitations), which can be a substantial benefit.

Contribution Limits: Traditional IRAs allow for tax-deductible contributions, while Roth IRAs do not. And if your income is over a certain amount (in 2025, modified adjusted gross income over \$165,000 for single taxpayers and \$246,000 for joint filers) you aren't eligible to contribute to a Roth IRA at all (although there are no income limits for contributions to employer-sponsored Roth accounts that are part of your employer's qualified retirement plan, including 401k, 403b, 457a, SEP-IRA and SIMPLE-IRA).

If your income exceeds the limit that would allow you to contribute directly to a Roth IRA, you might be able to take advantage of a technique known as

a "backdoor Roth" (described later) to create a tax-free pool of money to fund your future goals, but that technique is only available in particular circumstances. If you are able to contribute to either a Roth or a traditional IRA, you have to weigh the immediate tax benefits of a deduction for a contribution to a tax-deferred traditional IRA against the long-term tax-free growth potential of a Roth IRA.

Liquidity for Taxes: As discussed above, it's much more efficient to have sufficient liquidity outside the IRA to pay the taxes on the conversion. Using IRA funds to pay taxes can reduce the amount available for tax-free growth in the converted account and may also incur a 10% early withdrawal penalty if you are younger than 59½. Paying taxes from assets outside the Roth IRA allows the entire converted amount to remain in the Roth account, enhancing its growth potential.

Impact on Living Expenses: If you rely on IRA funds for living expenses, converting to a Roth IRA may not be ideal. The immediate tax liability could deplete resources you need for your day-to-day expenses, making it more prudent to maintain the traditional IRA for its tax-deferral benefits. You would effectively be pre-paying the tax you'd pay when you eventually withdrew the money from the IRA, which is not particularly efficient.

Potential alternatives: Converting a traditional IRA to a Roth IRA accelerates the tax—when you convert you are effectively prepaying the full amount of the tax you'd pay over time as you take required minimum distributions (RMDs) once you reach the age at which you're required to do so. If you have charitable goals, consider naming a charity as your traditional IRA beneficiary. While you would have to take RMDs once you reached the minimum age, leaving an IRA to charity avoids both estate tax on the IRA balance (your estate gets a full charitable deduction) and the income tax on withdrawals, since the charitable beneficiary is not taxable. And if you name as the charitable beneficiary a private foundation or donor-advised fund that your spouse and children control, you can effectively give them a charitable "pocketbook" from which they can make contributions to causes that are important to them.

Example: Roth IRA Conversion vs. Non-Conversion

Traditional IRA

John, aged 50, has a traditional IRA worth \$100,000. He expects to be in a higher tax bracket in retirement and is considering converting to a Roth IRA.

Roth IRA Conversion; tax paid out of other assets

If John converts his entire IRA, he will pay taxes on the \$100,000 at his current tax rate. Assuming a 24% tax rate and assuming that the \$100,000 does not push him into a higher bracket, he will owe \$24,000 in taxes. If the Roth IRA grows at an average annual rate of 6%, it would double in approximately 12 years, reaching about \$200,000 by age 62 and about \$400,000 by age 74. No withdrawals would be required from this account, but any withdrawals John did take would be tax-free.

Roth IRA Conversion; tax paid out of IRA assets

If John converts his IRA but pays the tax out of the converted amount, he would owe \$24,000 plus a \$2,667 penalty (the 10% penalty would also be assessed on the amounts used to pay the penalty), leaving only \$73,333 to grow. Again assuming an average annual return of 6%, that would grow in 12 years to about \$146,667 and in 24 years to about \$293,332. John would have over \$100,000 less in the tax-free Roth account if he paid the tax out of the IRA than if he paid it out of other assets.

Non-Conversion

If John does not convert, his traditional IRA will continue to grow tax-deferred. Assuming the same growth rate, the IRA will also double to \$200,000 by age 62 and to \$400,000 by age 74. However, withdrawals beginning at age 75 would be taxed as ordinary income, reducing the net benefit. Depending on how long John lives, though, this could still be a better outcome for him than having converted and paying the taxes out of IRA assets—and can be a good solution if he names a charity as his beneficiary.

Tax Payment

John needs to be aware that in the conversion scenario, he may use liquid assets outside the IRA to pay the tax. In the non-conversion scenario, John may still have these assets growing for his retirement in a taxable account.

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Advantages of Conversion	Disadvantages of Conversion
Tax-Free Growth: Roth IRAs offer tax-free growth and withdrawals, which can be advantageous if tax rates increase in the future or if you end up in a higher tax bracket when and if you take withdrawals.	Immediate Tax Liability: The conversion triggers a tax liability, which can be a financial burden, and effectively pulls forward to the current year taxes that might not otherwise be due until many years in the future, and even then only on fractions of the account (the RMD) each year.
No RMDs: Roth IRAs do not require RMDs during the account owner's lifetime, allowing for more flexible retirement planning.	Potential for Higher Tax Bracket: The conversion may push the individual into a higher tax bracket.
Beneficiary Benefits: Non-spousal beneficiaries can inherit a Roth IRA and withdraw funds tax-free, providing an advantage over traditional IRAs.	Need for External Funds: Paying the tax liability from assets outside the IRA is helpful to preserve the growth potential of the Roth IRA, but it requires sufficient liquidity.

Impact on Non-Spouse Beneficiaries

For non-spousal beneficiaries, inheriting a Roth IRA can be more advantageous than a traditional IRA because of the tax-free nature of the withdrawals. Since many non-spouse beneficiaries must take RMDs from an inherited IRA—traditional or Roth—and must empty the account within 10 years after the original owner’s death, the benefits vary depending on the identity of the beneficiary.

Minor Children: If the beneficiary is a child of the original account owner and is a minor, special rules apply. The minor is not subject to the 10-year rule until the minority ends. For example, if a 15-year-old inherits a Roth IRA in 2025 (due to their parent's death in 2025), they must begin taking RMDs based on their life expectancy starting in 2026. These RMDs will continue annually. Assuming the age of majority is 21, the beneficiary will reach the age of majority in 2031. By the end of 2041, ten years after reaching the age of majority, the minor must fully distribute the inherited account. This timeline ensures that the tax-free benefits of the Roth IRA are maximized during their earlier years, providing a financial cushion as they transition into adulthood.

Since minors are required to take minimum distributions and, because of the “kiddie tax”, often pay tax at their parents’ rate, the value of a Roth IRA vs a traditional IRA is potentially higher while the minor is subject to the kiddie tax.

Grandchildren as Beneficiaries: Tax Deferral and Generation-Skipping Transfer Tax

Designating grandchildren as beneficiaries of a Roth IRA can significantly enhance the value of the inheritance through tax-free growth. Unfortunately, while grandchildren do not benefit from the rules for minor children, if they are required to take RMDs they still get the benefit of tax-free withdrawals and, if they are minors when they inherit a grandparent’s Roth IRA, would avoid income tax at potentially high rates due to the kiddie tax.

However, designating grandchildren as beneficiaries may raise considerations regarding the Generation-Skipping Transfer (GST) Tax. The GST tax is a federal tax imposed on transfers to individuals who are two or more generations below the donor, such as grandchildren. This tax is designed to prevent the avoidance of estate taxes through generation-skipping

transfers. When planning to leave a Roth IRA to grandchildren, it's essential to consider the potential GST tax implications and ensure that any transfers fall within the available GST tax exemption limits.

Consulting with a tax advisor or estate planning professional can help navigate these complexities and ensure that the transfer of IRA assets aligns with your overall financial and estate planning goals.

Trust as a Beneficiary

Designating a trust as a beneficiary of a Roth IRA can offer strategic advantages, particularly in estate planning. Two primary types of trusts can be used: accumulation trusts and conduit trusts. Both of these have to be written very carefully, so working with an estate planning lawyer is critical to ensure that your wishes are carried out.

	Advantages	Disdvantages
Accumulation Trust	RMDs may still have to be made from the IRA to its beneficiary (the trust) each year after the death of the original owner, and the full amount of the IRA still has to be withdrawn after 10 years. An accumulation trust allows the trustee to retain distributions within the trust, providing control over the timing and amount of distributions to beneficiaries. This can be beneficial for managing the financial needs of beneficiaries and protecting assets from creditors.	Retaining distributions within the trust may result in higher tax rates, as trust income is typically taxed at higher rates than individual income. The life expectancy used to determine RMDs is that of the oldest beneficiary of the trust, which can result in more money coming out sooner if there are multiple trust beneficiaries.
Conduit Trust	A conduit trust requires the trustee to pass distributions directly to the beneficiaries. This can simplify tax reporting and provide beneficiaries with immediate access to funds. The life expectancy used to determine RMDs is based on the age of the oldest beneficiary of the trust.	The trustee has less control over the timing and amount of distributions, which may not be ideal for beneficiaries who need financial management or protection from creditors. Choosing between an accumulation trust and a conduit trust depends on the specific goals and needs of the estate plan. Consulting with an estate planning professional can help determine the most appropriate trust structure for maximizing the benefits of an inherited Roth IRA.

Scenario with No Other Beneficiaries

In cases where there are no other beneficiaries, the decision to convert a traditional IRA to a Roth IRA may depend on the individual's long-term goals and tax situation. If you expect to be in the same or a higher income tax bracket in retirement and you want to diversify the tax status of your sources of income,

converting to a Roth IRA can be beneficial, as it allows for tax-free withdrawals later when your taxes might be higher. However, if you plan to leave the IRA to charity or otherwise don't expect to need tax-free money, prepaying taxes might not fit in with your plans and conversion may not be necessary.



Emotional Factors

In addition to the financial factors discussed above, the emotional impact of converting to a Roth IRA can be significant. The decision involves a trade-off between immediate financial cost (the tax you'll pay up front) and longer-term benefits (tax-free withdrawals and no RMDs). If you convert you may experience anxiety over the potential for future tax law changes or regret if the conversion does not yield the expected benefits. This could also cause you not to act at all.

Additionally, the decision can affect family dynamics, especially when considering the impact on beneficiaries. Leaving a tax-free bucket of assets to the next generation can provide you with peace of mind, knowing that your heirs will benefit from tax-free distributions.

A key aspect of the decision about whether to convert is the anticipation of future tax rates, which can be uncertain and anxiety-inducing. If you expect your tax rate to rise, converting to a Roth IRA may be advantageous, as it locks in the current tax rate on the conversion amount. Conversely, if your tax rate is expected to decrease, it may be beneficial to defer conversion or not do one at all. Predicting the future accurately is difficult if not impossible—this decision requires a thoughtful analysis of economic trends, government policies, and personal financial projections and assumptions, all of which can be emotionally draining.

Conclusion

Converting a traditional IRA to a Roth IRA is a complex decision that involves weighing immediate financial costs against long-term benefits. It requires careful consideration of tax implications, future income and tax-rate expectations and the impact on beneficiaries. By understanding all of the factors that go into this decision, you can make informed choices that align with your financial goals and retirement plans.

Your J.P. Morgan advisor can help you think through your choices and can work with your tax and legal advisors to help you make the best decision for you and your family.

Side Bar: Eligible Designated Beneficiaries Not Subject to the 10-Year Rule

Surviving Spouse: Can stretch distributions over their lifetime.

Minor Children of the Account Owner: The 10-year deadline to empty the account is postponed until the minor reaches the age of majority.

Disabled Individuals: Can take distributions over their lifetime or until the disability is removed

Chronically Ill Individuals: Eligible for lifetime distributions while they are chronically ill.

Individuals Not More Than 10 Years Younger than the original account owner: Can stretch distributions over their lifetime.

Side Bar: Understanding the Backdoor Roth IRA

Backdoor Roth Strategy: Allows high-income earners to bypass income limits for direct Roth IRA contributions by making a nondeductible contribution to a traditional IRA and converting it to a Roth IRA.

Financial Advantage: Enables tax-free growth and withdrawals in retirement, potentially offering significant long-term benefits.

Key Considerations: Be aware of the pro-rata rule: if you have any other traditional IRAs that have pre-tax contributions your conversion will be at least partially taxable. You should also consider the timing of the conversion to help minimize taxes.

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