



Clearing up Roth Conversion Misconceptions

By Partners Wealth Management

Roth conversions are frequently spotlighted in mainstream media, garnering significant attention for their potential benefits. However, despite the buzz, people often misunderstand key aspects of this financial strategy.

Many individuals are drawn to the allure of Roth accounts offering tax-free income and may rush to convert funds from traditional retirement accounts, which are subject to taxable required minimum distributions (RMDs) starting at age 73 (or age 75 for those turning 74 in 2033 or later). However, the decision to opt for a traditional versus a Roth retirement account is highly nuanced and largely depends on the client's current and projected future tax rates.

This common knowledge gap creates a valuable opportunity for advisors to demonstrate their expertise. By preparing sophisticated projections comparing "with conversion" and "without conversion" scenarios, advisors can offer clear insights into the long-term implications of each choice.

Building Client Trust

Projections can effectively illustrate critical dynamics that clients may overlook, such as how required minimum distributions (RMDs) can increase the taxable portion of Social Security benefits. For high-income retirees, advisors can demonstrate how RMDs might result in higher premiums for Medicare Parts B and D due to income-related monthly adjustment amounts (IRMAA), or even trigger the 3.8% net investment income tax on portfolio earnings.

Avoiding Common Mistakes in Roth Conversions

Errors in executing Roth conversions are all too common. For example, without guidance, a client might miss the December 31, 2024, deadline for a 2024 Roth conversion, mistakenly believing they have until April 15, 2025, the deadline for IRA contributions for the same tax year.

The complex **pro-rata rule** also trips up many taxpayers, particularly those employing a “backdoor Roth” strategy. This occurs when someone makes a non-deductible contribution to a traditional IRA and then converts it to a Roth IRA. They often don’t realize that the tax owed on the conversion considers the year-end balances of **all** their traditional IRAs, including SEP-IRAs and SIMPLE IRAs—not just the account being converted. This oversight can lead to unexpectedly high taxes on the conversion.

Additional pitfalls arise when clients overlook minor traditional IRA balances or make changes later in the year. For instance, they might execute a backdoor Roth conversion early in the year, only to switch jobs later and roll a 401(k) from their old employer into a traditional IRA. Such actions result in a year-end traditional IRA balance, triggering the pro-rata rule.

To avoid these issues, advisors can take proactive steps. Before year-end, consider rolling traditional IRA funds into the client’s current employer plan, provided the plan has reasonable fees, suitable investment options, and allows IRA rollovers. By doing this, the client avoids having a traditional IRA balance at year-end, effectively bypassing the pro-rata rule.

Navigating Tax Withholding Pitfalls in Roth Conversions

Many people misunderstand the tax implications of Roth conversions, particularly regarding withholding. When taxes are withheld from the converted amount, it counts as a taxable distribution, and if the individual is under age 59½, it triggers a 10% early-withdrawal penalty.

If you’re over 59½ and a Roth conversion aligns with your financial goals, it can be wiser to proceed and have the taxes withheld from the conversion amount than to skip it entirely. This approach avoids penalties and preserves the opportunity for future tax-free growth within the Roth account.