

SAVING & INVESTING FOR RETIREMENT

THE ROTH CONVERSION

Most Americans who invest in a Roth IRA contribute directly, invest, and let it grow. This is great! However, high-income earners are not able to join the party. If a single filer earns more than \$165,000 per year, they are no longer eligible to contribute directly to a Roth IRA.

So, how can high-income earners take advantage of this powerful retirement account?

I'm an evangelist for the Roth IRA, and it pains me that there is so much about it that is misunderstood. This paper explains the Roth Conversion, which is a step beyond the basics. If you need a refresher on Roth IRA fundamentals, you can read our paper [Setting up the Next Generation for Success Part II: The Roth IRA](#).

There are some distinct differences that make the Roth IRA a better choice for parents of teens and young adults. The main difference between a traditional IRA and a Roth IRA is in the contributions, or funding of the account.

Roth Conversion

At any time, the owner of a traditional IRA can convert it to a Roth IRA. This requires paying taxes on the converted funds and filing the appropriate IRS forms. Let's use a case study to see how this works.

Sally is a working professional in her early 30s. Ten years ago, she contributed \$10,000 to a traditional IRA from a part-time job in college. After graduating, Sally began working at a large company and contributed regularly to her 401(k). Now, she has decided to take a year-long sabbatical to travel and explore new career paths. She has savings to cover her expenses and does not expect to earn income during the year.

- Current traditional IRA Balance: \$20,000
- Current 401(k) Balance: \$80,000



After leaving her job, Sally rolls her 401(k) into her traditional IRA to simplify management. Since both are pre-tax accounts, there are no fees or penalties for the rollover. Her new traditional IRA balance is \$100,000.

Since she expects to have no income during the sabbatical, Sally decides to convert the full \$100,000 to a Roth IRA, recognizing \$100,000 as taxable income. Assuming her effective tax rate is 25%, she pays \$25,000 in taxes using her savings.

This leaves her with \$100,000 in her new Roth IRA, where **it will grow tax-free**. Once she reaches retirement age, **she can withdraw the funds tax-free and penalty-free**.

After her sabbatical, Sally lands a higher-paying job earning \$200,000 per year. Although her new company offers a 401(k), Sally wants to contribute even more to her retirement savings. Her advisor suggests a Backdoor Roth Contribution.



Backdoor Roth Contribution

Since Sally's income makes her ineligible for direct Roth IRA contributions, her advisor explains that she can still contribute up to \$7,000 annually to a traditional IRA. Although the contribution is not tax-deductible, Sally can immediately convert it to a Roth IRA without paying additional taxes.

Sally is initially confused and asks, "Won't I pay taxes twice if I convert my non-deductible contribution to a Roth?"

Her advisor clarifies: Only untaxed funds in a traditional IRA are taxed during a conversion. Since the \$7,000 contribution was made with after-tax funds, there are no additional taxes when converting to a Roth IRA.

In essence, **Sally can contribute \$7,000 to a Roth IRA** as if her income were below the eligibility limit by routing the contribution through a traditional IRA first. The Backdoor Roth strategy **nullifies the income limits on direct Roth IRA contributions**.



The Pro-Rata Rule

In some cases, the Backdoor Roth strategy is not as simple. The complexity arises when a traditional IRA contains both pre-tax and after-tax funds.

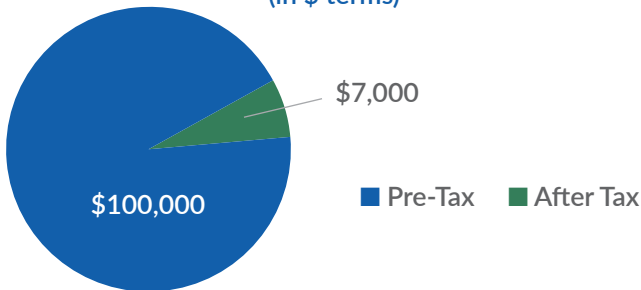
When performing a conversion, the IRS does not allow you to choose which funds are converted first. Instead, it applies the pro-rata rule, which calculates the taxable portion of the conversion based on the **ratio of pre-tax to total IRA balances**. For example:

- If 100% of Sally's traditional IRA funds are pre-tax, 100% of the conversion is taxable.
- If 50% of her traditional IRA funds are pre-tax, then 50% of the conversion is taxable.

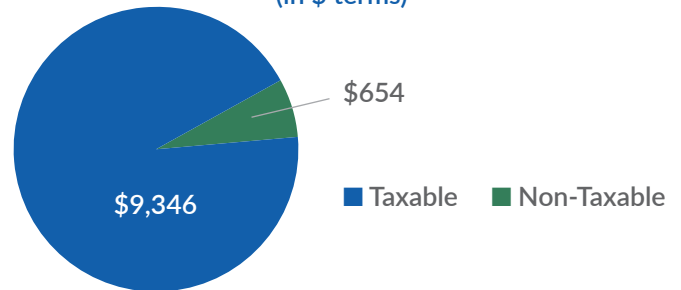
In Sally's case, if she had never taken her sabbatical, but still changed jobs and rolled her 401(k) into her traditional IRA, the Backdoor Roth strategy would be more complicated. Let's use the same figures as before to see how this works.



Traditional IRA Total Value Composition
(in \$ terms)

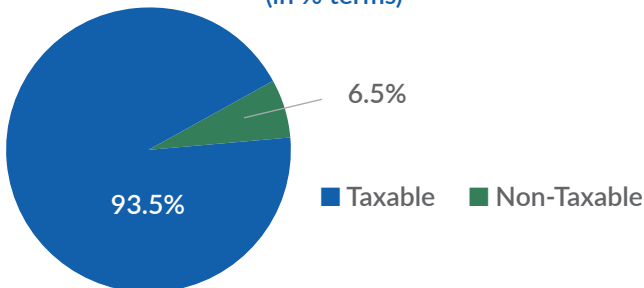


\$10k Roth Conversion Taxation Composition
(in \$ terms)

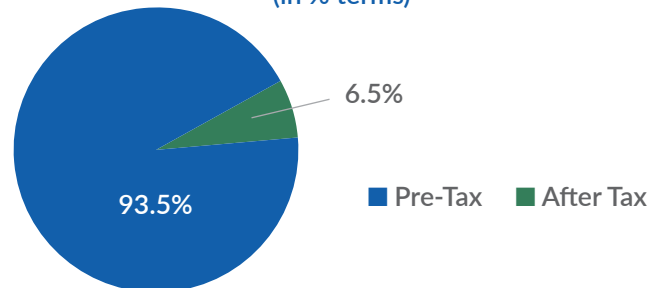


Sally has a total IRA balance of \$107,000 after the non-deductible contribution of \$7,000. This means \$100,000 of her IRA balance is pre-tax (93.5%) and \$7,000 is after-tax (6.5%). If she converts \$10,000 to a Roth IRA, then 93.5% of the conversion (\$9,350) would be treated as taxable income.

\$10,000 Roth Conversion Taxation
(in % terms)



Traditional IRA Total Value Composition
(in % terms)



Conclusion

The Roth Conversion is an excellent strategy in two scenarios, both of which Sally exemplified in our earlier examples:

1. **Minimal or no income with a large traditional IRA balance.**
2. **High income with a small or no pre-tax traditional IRA balance.**

If you fall into one of these categories, consider reaching out to your financial advisor to discuss a Roth IRA Conversion. It can have a significant impact on your long-term financial future.



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