Helping Clients Conquer Roth Conversion Misconceptions

NOVEMBER 5, 2024 • ERIC REINER

Roth conversions get major coverage from the popular press these days. Yet despite the hoopla, many prospective and existing clients harbor misguided beliefs about this potentially valuable planning technique.

Crucially, "people don't always understand the tax implications of a Roth conversion and just pick an arbitrary number" to convert, says Christopher Fundora, director of retirement planning at Traphagen CPAs & Wealth Advisors in Oradell, N.J.

Folks hear Roths can deliver tax-free income and they trip over themselves to convert money from traditional retirement accounts, which churn out taxable required minimum distributions starting at age 73 (age 75 for individuals turning 74 in 2033 or later). But they often fail to grasp that the choice between a traditional and Roth retirement account hinges largely on arbitraging their current and projected future tax rates.

The knowledge gap gives advisors a golden opportunity to showcase their value with a sophisticated projection contrasting "with conversion" and "without conversion" scenarios. "You have to do multi-year planning with the client, into RMD age, to see if you can really justify a conversion," says Jim Holtzman, CEO of Legend Financial Advisors Inc., in Pittsburgh.

Gaining Trust

Use the projection to highlight important dynamics few people would think to consider, such as the impact of their required distributions on the taxable percentage of social security benefits. With high-income retirees, show how RMDs could lead to larger premiums for Medicare Parts B and D due to the income-related monthly adjustment amount, or subject portfolio income to the 3.8% net investment income tax.

Discuss with the affluent a potential conversion's estate planning implications. "If the client is financially set, it might be worth doing a conversion because they can afford to and their heirs can inherit the Roth and let it grow tax-free for 10 years. Now you're looking at a multi-generational projection that extends the horizon 10 years past the client's expected date of death," Holtzman says.

"When you start making these points to a prospect, they realize, 'Oh, wow, there's a lot to this,'" he says. "And I give them good stories about when it made sense [for a client to convert], when it made sense not to, and the in-between side of it, where it's not obvious one way or the other and you take a leap of faith on some of the assumptions and maybe convert some, just to hedge bets on tax rates or changes in their situation."

Maladroit Execution

Procedural goofs are frequent, practitioners say. For instance, absent your intervention, someone might miss the December 31, 2024, deadline for a 2024 Roth conversion, erroneously thinking they have until April 15, 2025, the due date for 2024 IRA contributions.

The nefarious pro-rata rule ensnares many unsuspecting taxpayers, especially those who conduct a so-called "backdoor Roth" by making a non-deductible contribution to a traditional IRA and subsequently converting the account to a Roth. They often don't realize that the tax calculation on a Roth conversion takes into account the year-end balances of all their traditional individual retirement accounts, including SEP-IRAs and SIMPLE IRAs, not just the account being converted.

The end result? Coughing up more tax on the conversion than bargained for.

Sometimes clients who complete Roth conversions simply forget about a small traditional IRA they have, no matter how much the advisor presses them about the entirety of their retirement accounts. Or perhaps they carry out a backdoor Roth conversion early in the year, switch jobs later in the year, and in the process roll a traditional 401(k) at the old employer to an IRA.

In both of these situations the client will have a traditional IRA end-of-year balance, triggering the pro-rata rule, says Matt Saneholtz, president and senior wealth advisor at Tobias Financial Advisors in Plantation, Fla.

To remedy such cases, before the year ends consider rolling the traditional IRA to the client's employer plan, assuming its fees are reasonable, the investment choices meet the client's objectives, and the plan allows incoming IRA rollovers, Saneholtz advises.

"Now we can start the backdoor Roth and the pro-rata rule doesn't come into play," he tells clients as he presents a diagram of all the steps, from rolling the traditional IRA to the employer plan through converting the current-year IRA contribution to a Roth.

Befuddled By Withholding

Not everyone realizes that income tax withheld from a Roth conversion counts as a taxable distribution and if they're under age 59½, the 10% early-withdrawal penalty applies.

Another miscue is converting an IRA, deciding not to have tax withheld, then failing to make the necessary estimated tax payment. "They forget about it or figure, 'This will all work out in the end,' and they wind up with an estimated tax penalty," says planner Jeremy Keil, at Keil Financial Partners in New Berlin, Wis.

To him, the most costly blunder is made by those who know they should make an estimated tax payment if they convert but conclude that the conversion's tax cost would exceed the cash they have handy. So they abandon the conversion.

"There's this false belief that if you don't have the money to make an estimated tax payment, you shouldn't bother with a Roth conversion," Keil observes. "But if you're over 59½ and it makes sense to convert, you're better off converting and having tax withheld as opposed to not doing it at all."

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