ROTH CONVERSION – OOPS!

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An advisor called to discuss Roth IRA conversions. His new client made some decisions before speaking with him, and he was trying to untangle her self-inflicted knot. She was 69 years old, a single tax filer, still employed, and had a $1 million traditional IRA. Based on advice from her brother (who is not a financial professional), she had already ripped through Roth conversions of $200,000 for both 2021 and 2022. The brother's only consideration in making his recommendation was, "The market is down."

Uh-oh. And now we face the consequences.

First and foremost, Roth conversions cannot be undone. There is no recharacterizing a Roth conversion. (Roth contributions can still be recharacterized, but that is a different topic.) So, these $200K conversion knots could not be untied. Regardless, we still needed to explain the ramifications of the transactions and how to approach things differently in the years to come.

Taxes. Assuming this person had no after-tax dollars (basis) in her traditional IRA, then the entire conversion would be taxable. This year she added $200K of ordinary income to her roughly $50,000 of expected earnings. For a single filer who took the standard deduction in 2021 and will do so again in 2022, these balloon conversions most likely vaulted her from the 12% tax bracket all the way up to the 35% bracket. Maybe, with some creative planning, we could finagle a way to get her down to the 32% bracket, but she is definitively facing higher taxes.

A better solution would have been to consider tax brackets before she locked in a Roth conversion. Yes, the markets may be down as her brother said, but the tax brackets are stable. More precise conversions could have limited her to the 22%

bracket or, if she was willing, inched her into the 24% bracket. For taxpayers who think rates will increase in the near future, maybe filling up the 24% bracket now (or even the 32% bracket) makes sense.

IRMAA. While tax brackets are steps, Income Related Monthly Adjustment Amount (IRMAA) surcharges for Medicare are a cliff. One dollar over an IRMAA bracket level and you dive headfirst into the next pool. As a single filer with $50,000 of income, this woman was in the bottom IRMAA bracket. By adding a $200,000 Roth conversion in both 2021 and 2022, she jumped to one of the highest brackets and will significantly increase her monthly costs in 2023 and 2024. (IRMAA charges are based on modified AGI from two years previous.) Take note - it is not just income tax brackets that must be considered before a conversion, but “stealth taxes” like IRMAA surcharges must also be part of the equation.

RMDs. Required minimum distributions had not yet kicked in for this individual. She was only 69 and still had a few years to go. Yes, converting her entire traditional IRA before 72 would eliminate the need to take an RMD. But at what cost? For those already taking RMDs, be aware that an RMD cannot be converted. Once satisfied, anything above and beyond the RMD can then be converted.

Financial aid can also be impacted by a Roth conversion, as can other income-based programs and benefits. Before doing any Roth conversion, be sure to weigh all factors, not just market conditions. Every person is different, and we all have personal goals and opinions. An “oops” conversion for one individual could be a home run for another. Tread carefully.