A GUIDE TO ROTH IRA CONVERSIONS

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A Guide to Roth IRA Conversions

Overview

There are many ways to invest your money to help reach your financial goals. One common retirement investment option is a Roth IRA. This guide explains some of the advantages and disadvantages of Roth IRAs, how Traditional IRA, IRA Rollover or certain qualified plan assets can be converted into Roth IRAs and who might benefit from these types of accounts. Deciding whether a Roth IRA conversion makes financial sense largely depends on your current and future tax rates, time horizon and planned distributions.

Types of IRAs

Typically, most investors have the option of contributing to a Traditional IRA or a Roth IRA, even if you have an employer-sponsored retirement plan such as a 401(k), 403(b) or 457(b). Most investors also have the option of converting retirement assets into a Roth IRA. Traditional and Roth IRAs each have unique benefits and Internal Revenue Service (IRS) limitations, including contribution and tax deductibility limitations—the key difference is when you pay income taxes.

With a Traditional IRA, your contributions are generally tax deductible and grow tax-deferred.* Distributions from a Traditional IRA are taxed as ordinary income, and Required Minimum Distribution (RMD) rules apply once you reach a certain age:

Required Minimum Distribution (RMD) Starting Age by Birthdate	
Account owners born on or before 6/30/1949	70.5
7/1/1949 through 12/31/1950	72
1/1/1951 through 12/31/1959	73
Account owners born on or after 1/1/1960	75

For a Roth IRA, contributions are made with money that has been taxed before going into the account—post-tax dollars. Roth IRA contribution eligibility is dependent on your tax filing status and Modified Adjusted Gross Income (MAGI). Contribution rules based on MAGI can be found in chapter 2 of IRS Publication 590-A. High-income earners are prohibited from contributing to a Roth IRA.*** However, they can utilize what is commonly called a "Backdoor" Roth IRA where they contribute up to the allowable limits to a non-deductible IRA (subject to the IRS' pro- rata rule**) and convert those funds into a Roth IRA.

Roth IRA Conversions

Roth IRA conversions transform Traditional IRA assets into Roth IRA assets. While Roth IRA contribution amounts depend on

*Nondeductible contributions to a Traditional IRA are subject to different rules. Consult your tax advisor for details.
**The Pro Rata Rule requires IRA owners to consider all of their Traditional IRAs as the same account. It prevents IRA owners from only converting non-deductible IRAs (after tax) to Roth IRAs and thereby avoiding the taxes that would normally be involved in the conversion process. See IRC Section 408(d)(2).
***https://www.irs.gov/pub/irs-pdf/p590a.pdf

your MAGI, there are no income eligibility requirements for Roth conversions. An investor can convert as much as they like from a Traditional IRA into a Roth IRA, but the converted funds are subject to federal (and state, where applicable) income taxes. It's often best to pay the related income taxes from an after-tax account or cash. This is because using IRA funds to pay the taxes reduces the amount converted into a Roth IRA dollar-for-dollar and simultaneously increases your taxable income.

With a Roth IRA conversion, you are transforming fully taxable future income to tax-free income. By paying taxes up front, you won't have to pay taxes when you choose to or are required to take distributions during retirement. Consequently, Roth IRA conversions can potentially impact other resources such as Medicare and Social Security, so it's best to review your situation with a money manager and tax advisor to know what to expect before taking any action.

When should you consider a Roth Conversion?

There are a number of factors to consider when deciding to convert assets—consulting with both a money manager and tax advisor can help assure that proper due diligence is afforded in understanding how a Roth IRA conversion strategy may or may not benefit you.

A Roth IRA conversion may be part of a successful strategy for you if some of the following applies:

- You are over the age of 59 ½.
- You have sufficient after-tax funds to pay the resulting income taxes.
- You reasonably expect to be in the same or higher federal and/or state income tax brackets in retirement.
- You have other losses or deductions to offset the taxes resulting from the conversion.
- You have, or expect to have, sufficient cash flow sources to support your ongoing expenses outside of Traditional IRA assets.
- You reasonably expect to only take RMDs from your Traditional IRA.
- Your Traditional IRA is reduced in value from market volatility (which would make the tax impact of conversion less onerous than when the market and your account value recover).

Advantages of a Roth IRA

One advantage of a Roth IRA is there are no RMDs. Distributions from IRAs are considered ordinary income, which could propel you into a higher tax bracket.

Since Roth IRAs are not subject to RMDs, your money can keep growing tax-free and you can have tax-free withdrawals during retirement. This flexibility can be advantageous for larger purchases and gifting efforts—particularly if you anticipate having relatively high or steady streams of income in retirement.

Disadvantages of a Roth IRA

You will have to pay federal and state income tax (where applicable) on the converted balance in the tax year the conversion occurs. Relatedly, the taxable income can potentially impact Medicare Part B and Part D premiums (details on page 11).

The IRS considers all of your Roth IRAs as one Roth IRA. In the event you have more than one Roth IRA, the five-year holding period starts when any one of your Roth IRAs are established.

In order to take tax-free withdrawals from Roth IRAs, you need to abide by the IRS' five-year rules. Additionally, the IRS has established distribution ordering rules: 1) contributions; 2) conversions (pre-tax converted assets, then after-tax converted assets); and lastly 3) earnings.

For Roth IRA ***contributions,*** the five-year holding period is based on January 1 of the year when you first establish a Roth IRA.

For example, the holding period for a Roth IRA opened and contributed to (even with as little as $1) in October of 2020, actually begins as of January 1, 2020.

If you are under the age of 59 ½:

- As long as you do not have Roth IRA conversions in the prior five years, only earnings distributed will be subject to ordinary income taxes and a 10% penalty.

- If you have Roth IRA conversions within the prior five years, distributions of pre-tax converted funds will be subject to a 10% penalty; earnings distributed will be subject to ordinary income taxes and a 10% penalty.

If you are over the age of 59 ½:

- No ordinary income taxes or penalties on any distributions (including earnings) if you have had any Roth IRA open for more than five years.

- Earnings distributed will be subject to ordinary income taxes (no penalties) until you have a Roth IRA open for five years.

Roth IRA ***conversions*** are subject to a five-year period based on January 1 of the year in which assets were converted:

If you are under the age of 59 ½:

- Each amount converted to a Roth IRA is subject to a unique five-year period for tax-free withdrawals of the principal – specifically created to prevent taxpayers from circumventing early distribution penalties.

- Distributions of pre-tax converted funds will be subject to a 10% penalty; earnings distributed will be subject to ordinary income taxes and a 10% penalty.

If you are over the age of 59 ½:

- No ordinary income taxes or penalties on any distributions (including earnings) if you have had any Roth IRA open for more than five years.

- Earnings distributed will be subject to ordinary income taxes (no penalties) until you have a Roth IRA open for five years.

In addition, a Roth IRA conversion is irrevocable—meaning, once you finalize a Roth IRA conversion, you can't reverse it. The Tax Cuts and Jobs Act of 2017 (TCJA) eliminated the taxpayer's ability to re-characterize Roth IRA conversions made in 2018 or later.

There are numerous ways for an investor to accomplish a Roth IRA conversion. A few common ways of converting Traditional IRA assets into Roth IRA assets include: a full conversion, a staggered or partial conversion over a number of tax years, and "converting the gap"—a variation of a staggered conversion that helps ensure the investor remains within their tax bracket.

Let's examine a few hypothetical examples of investors considering Roth IRA conversions using these strategies.

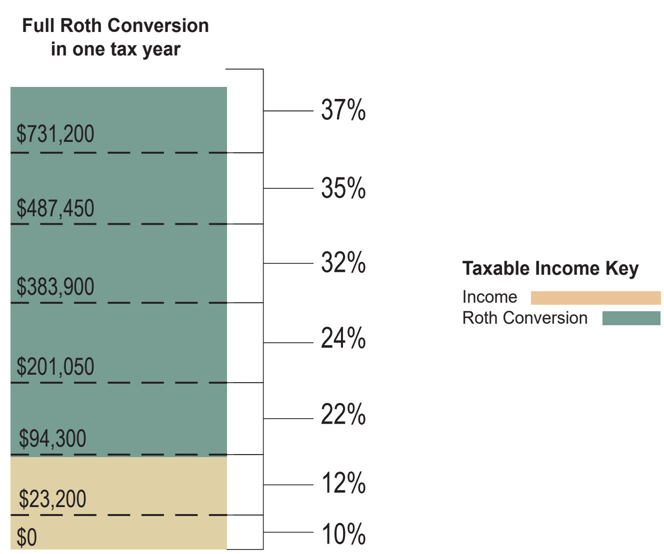
Meet Investors:
Jim & Carol

Imagine investors Jim and Carol, both age 62, have amassed $750,000 in Traditional IRA assets upon retirement. Their financial strategy, goals and objectives are based on the following:

- They reside in a state with no income taxes.
- They are in great health and likely have a 25-year time horizon.
- They have no debt, and their pensions and Social Security benefits provide an adjusted gross income (AGI) of $80,000/year, which comfortably covers their living expenses.
- They have an after-tax cash reserve balance of $250,000.
- They are seeking a moderate pre-tax return of 8% across their invested assets.
- They want to be able to take distributions at their discretion, rather than being forced to—especially during periods of negative volatility.

Federal Income Tax Bracket for Married Filing Jointly

Utilizing the standard deduction and 2024 federal income tax brackets



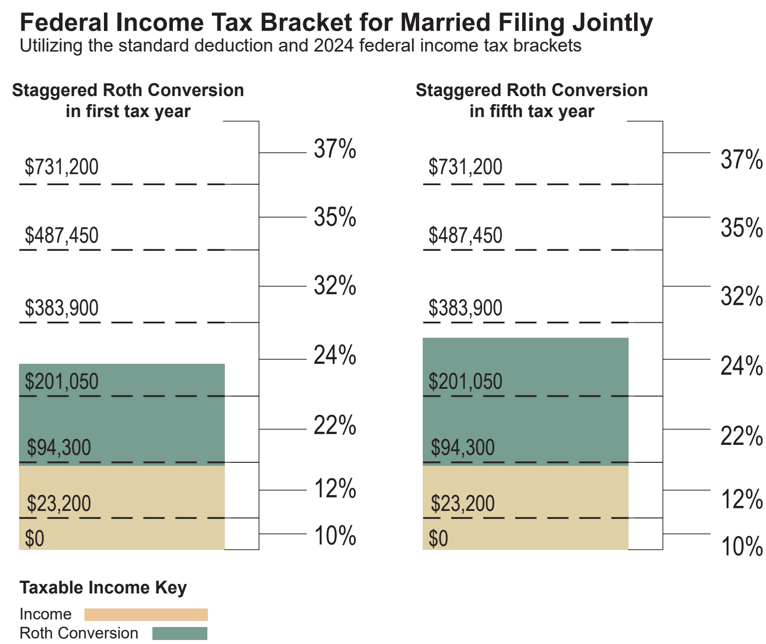
Jim and Carol's Conversion Options

Option # 1: "Full Conversion"

A full Roth IRA conversion of their $750,000 Traditional IRA would trigger a federal income tax bill of ~$217,000 (due to moving from the 12% into the 37% federal tax bracket). After paying the income taxes, they would have ~$33,000 remaining in their after-cash reserves.

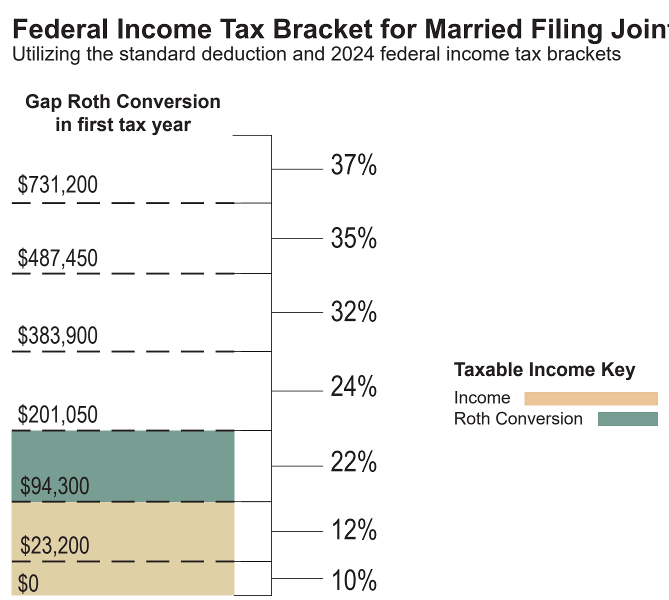
Option #2: "Staggered Conversion"

Perhaps Jim and Carol like the idea of a Roth IRA conversion, but they are uncomfortable with reducing their cash reserve to the level a full conversion requires. Instead, Jim and Carol want to stagger conversions to one-fifth of their IRA balance each year. In Year 1, they would convert $150,000 and would owe ~$28,500 in federal taxes (moving from the 12% into the 22% federal tax bracket.) Presuming an 8% pre-tax annual growth rate, Jim and Carol would convert increasing amounts annually over the subsequent four tax years, totaling ~$880,000 in Roth IRA assets, before shifting from the 24% bracket. After paying a total of ~$190,000 in taxes due to the conversions, they would have ~$68,000 in their cash reserves.



Option #3: "Converting the Gap"

Let's say Jim and Carol like the idea of a Roth IRA conversion, but only want to convert to the upper limit of the next tax bracket (22%). In this case, they could "convert the gap" between their $80,000 income and the $201,050 upper threshold for a total of $150,000 in Year 1. Again, presuming an 8% pre-tax growth rate and accounting for the expected increases to the standard deduction each year, this approach would take Jim and Carol seven years to convert a total of ~$900,000 into Roth IRA assets. (Note: federal tax brackets are scheduled to revert to pre-2018 rates in 2026). After paying a total of ~$186,000 in taxes due to the conversions, they would have ~$72,000 in their cash reserves.



Meet Investor: **Nancy**

After a discussion with her neighbors, Jim and Carol, Nancy is curious if converting her Traditional IRA to a Roth IRA makes sense for her. Nancy, age 74, and her late husband, Ron, amassed $500,000 in Traditional IRA assets. Her financial strategy, goals and objectives are based on the following:

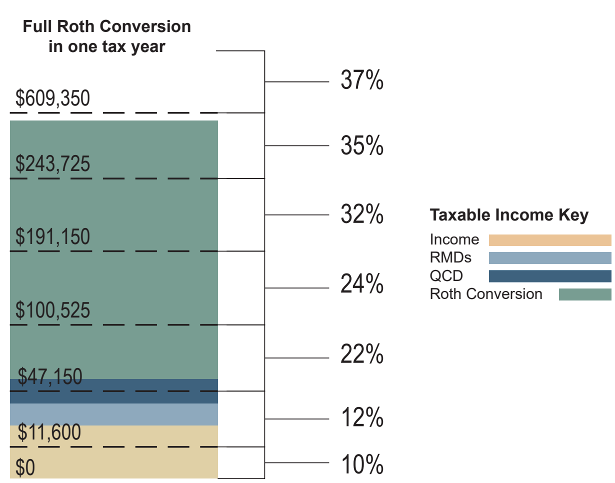
- She resides in a state with no income taxes.
- She is in great health and likely has a 20-year time horizon.
- She has no debt, and the survivorship benefits from Ron's pension, their Social Security benefits and ongoing RMDs provide an adjusted gross income (AGI) of $50,000/year, which comfortably covers her living expenses.
- She has an after-tax cash reserve balance of $175,000 from their savings and Ron's life insurance proceeds.
- She is seeking a modest pre-tax return averaging 5% across her invested assets.
- She typically takes only the RMD from her Traditional IRA in the late fall of each year. She donates $10,000 to her favorite charities through Qualified Charitable Distributions (QCDs) and then gifts the remainder to her adult grandchildren (QCDs allow up to $100,000/year to be transferred directly to qualifying tax-exempt organizations—this is excluded from taxable income, yet still count towards RMDs).
- She is intrigued by the flexibility a Roth IRA may provide in legacy planning for her heirs.

Nancy's Options

Option #1: "Full Conversion"

As Nancy is already subject to RMDs, converting the remaining ~$480,000 of her Traditional IRA to a Roth IRA would trigger ~$146,500 in federal income taxes (due to moving her from the 12% into the 35% federal tax bracket). This would largely deplete Nancy's cash reserves to ~$28,500.

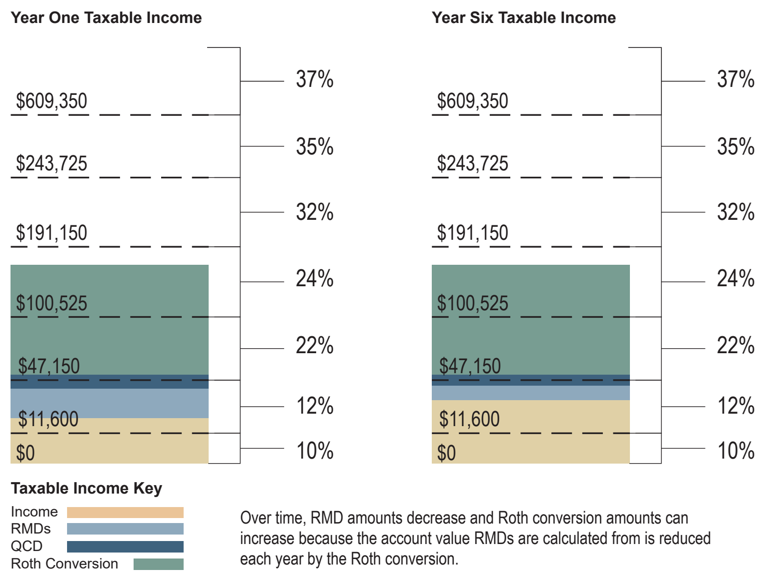
Federal Income Tax Bracket for Single Filing
Utilizing the standard deduction and 2024 federal income tax brackets



Option #2: "Staggered Conversion"

Perhaps Nancy likes the idea of a Roth IRA conversion and doesn't want to be subject to RMDs any longer, but depleting her cash reserve to the extent needed for a full conversion makes her uncomfortable. Nancy could stagger her conversions in concert with satisfying her RMDs to total $100,000 each year. For example, in Year 1 she would be required to distribute ~$19,500 to satisfy her RMD, leaving ~$80,500 available to convert to a Roth IRA. Due to the conversion, she would owe ~$16,500 in federal taxes, shifting from the 12% to the 24% bracket. Despite the decreasing RMD divisor factor (triggering larger RMDs) and a 5% pre-tax growth rate, Nancy would experience decreasing RMDs and increasing converted annual amounts. In total, Nancy would satisfy ~$69,000 in RMDs, while converting a total of ~$489,000 into Roth IRA in just six years.

Federal Income Tax Bracket for Single Filing
Utilizing the standard deduction and 2024 federal income tax brackets

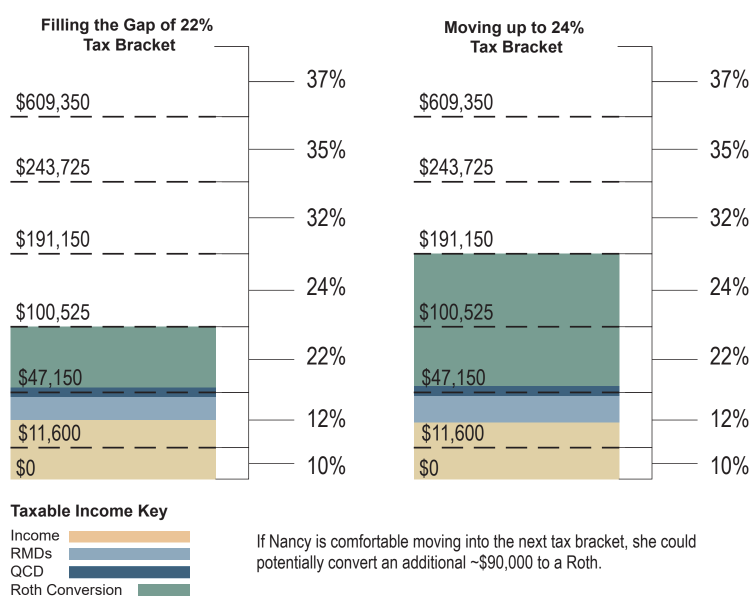


Over time, RMD amounts decrease and Roth conversion amounts can increase because the account value RMDs are calculated from is reduced each year by the Roth conversion.

Option #3: "Converting the Gap"

Due to her existing income sources, and utilization of QCDs as a portion of her RMDs, Nancy would only be able to convert ~$6,500 and still remain in the 12% federal income tax bracket. Given her 20-year time horizon, converting the gap to the upper end of the next bracket of $100,525 would allow ~$67,000 of conversion potential in Year 1—slightly increasing each year to absorb the modest changes to the bracket. With her portfolio designed to generate an average growth rate of ~5%, it would take Nancy seven years to convert a total of ~$490,500, while paying ~$108,000 in federal taxes. This would leave her with over ~$75,000 in her after-tax cash reserves.

Federal Income Tax Bracket for Single Filing
Utilizing the standard deduction and 2024 federal income tax brackets



If Nancy is comfortable moving into the next tax bracket, she could potentially convert an additional ~$90,000 to a Roth.

Other Types of Roth IRA Conversions

In Service Roth IRA Conversion

If your retirement plan permits in-service withdrawals, you can transfer up to the allowable amount into an IRA Rollover, which can be converted to a Roth IRA. Again, converting pre-tax dollars into Roth IRA assets triggers income taxes, but this mechanism can afford you greater tax diversity in terms of future sources of income.

Mega-Roth IRA

Roth IRA contributions are capped at $7,000 ($8,000 if you are age 50 or older) and subject to adjusted gross income (AGI) limitations. For many investors, their peak earning years are when they approach retirement and their higher AGI often prohibits them from being eligible to contribute to a Roth IRA.

However, there is no limit on the amount of a Roth IRA conversion. Investors actively participating in their 401(k), 403(b) or governmental 457(b) plans can utilize a conversion strategy known as the Mega-Roth IRA. This option allows you to contribute after-tax dollars to your employer's retirement plan (again, be sure to verify availability with your plan sponsor) and then convert the balance to a Roth IRA.

If permitted, you can contribute up to total of $69,000 as of 2024 federal tax brackets ($76,500 for those 50 or older) comprised of:

- Your pre-tax IRS limit of $23,000 ($30,500 for those 50 or older).
- Your after-tax contributions limited to $46,000 (less your employer's contribution).

Investors considering a Mega-Roth IRA need to pay special attention to the IRS' pro-rata rule and consider consolidating their Traditional IRAs, Rollover IRAs, Simplified Employee Pension (SEP) IRAs and Savings Incentive Match Plan for Employees (SIMPLE) IRAs into their employer-sponsored plan to avoid unintended consequences regarding conversions.[2]

Meet Investor: **Denise**

Denise is a 55-year old business executive with an AGI over $250,000 and is therefore unable to contribute to a Roth IRA. However, she enjoys her career, plans to continue working until she's 65, and her income comfortably exceeds her expenses, including taxes. Denise wants to ensure her retirement is equally comfortable by having abundant cash flows—particularly for travel and other discretionary expenses. Denise contacted her employer's benefits department and confirmed that in addition to her $30,500 contributions and her employer's match of $4,000, she can make up to $46,000 in after-tax contributions to her 401(k) each year. This after-tax balance can then be converted into a Roth IRA.

Will a Roth IRA conversion impact my Medicare premiums?

Possibly. It's important for investors participating in Medicare to understand the potential impact of a Roth conversion to their Medicare Part B and Part D. Medicare factors in *Income-Related Monthly Adjustment Amount (IRMAA)* monthly surcharges that directly reduce the investor's Social Security income depending on their taxable income.

These income-related adjustments are often overlooked because the IRMAA calculation is based on the income reported on the investor's tax returns from two years prior.

A Roth IRA conversion could impact an investor's Medicare Part B and Part D premiums two years in the future.

Income-Related Premiums For Parts B and D in 2024[3]

	Modified AGI	Part B Premium	Part D Surcharge
Single Married MFS*	\$0-\$103,000 \$0-\$206,000 \$0-\$103,000	\$174.70	\$0.00
Single Married	\$103,001-\$129,000 \$206,001-\$258,000	\$244.60	\$12.90
Single Married	\$129,001-\$161,000 \$258,001-\$322,000	\$349.40	\$33.30
Single Married	\$161,001-\$193,000 \$322,001-\$386,000	\$454.20	\$53.80
Single Married MFS*	\$193,001-\$500,000 \$386,001-\$750,000 \$103,001-\$397,000	\$559.00	\$74.20
Single Married MFS*	\$500,001 and above \$750,001 and above \$397,000 and above	\$594.00	\$81.00

Implementing a Roth Conversion
Logistics and Operations

How is a Roth IRA conversion taxed?

It is not as straightforward as one might think. Traditional IRA contributions are typically tax deductible, but may be limited if you (or your spouse) are covered by an employer retirement plan and your income exceeds certain levels. Deductible contributions—those made with funds that have not yet been subject to income taxes—along with any gains attributed to them are subject to federal and state (where applicable) income taxes upon withdrawal—having been deferred over their existence. If your Traditional IRA has only deductible contributions, you'll pay tax on the full amount. However, for non-deductible contributions, you only pay taxes on the earnings attributed to those contributions when completing a conversion.

Your custodian is responsible for tracking and reporting the accurate pro-rata amount on the 1099-R form. Be sure to verify what, if any, amount of your account is comprised of deductible versus nondeductible contributions prior to initiating a Roth IRA conversion.

Do securities need to be sold from my IRA to process a Roth IRA conversion?

No. The existing assets held in a Traditional IRA (stocks, bonds, etc.) can be journaled in-kind—meaning transferred as is—directly to a Roth IRA at most major custodians. This presents the advantage of maintaining your portfolio composition and market exposure during the conversion process and avoiding potential trading costs. There are three common ways you can work with your custodian to fulfill a Roth IRA conversion. A trustee-to-trustee transfer is the preferred method due to preserving your once per 365-day rollover provision, but it is not the only option.

**Married Filing Single*

- *Trustee-to-Trustee rollover*—have your Traditional IRA provider transfer the funds directly into your Roth IRA at a different custodian.
- *Same Trustee transfer*—if your IRA account is housed with the same provider simply ask the funds be transferred to the appropriate account.
- *Indirect rollover*—you receive a distribution from your traditional IRA (subject to a 20% federal tax withholding) and have 60 days to deposit it into a Roth IRA.

Additional Considerations: Estate Planning with Roth IRAs

By definition, IRA assets are owned by the individual and therefore considered part of the individual's gross estate at death. As a result of the SECURE Act, with the exception of Eligible Designated Beneficiaries (EDBs)—including surviving spouses, certain minor children until they reach age of majority, disabled and chronically ill individuals, and beneficiaries not more than 10 years younger than the decedent—IRA beneficiaries must deplete an inherited IRA within 10 years of the account owner's death.

This effectively eliminated "Stretch IRAs"—where a beneficiary only had to distribute smaller RMDs based on their life expectancy while allowing inherited IRA assets to continue growing tax-deferred. Distributions from Roth IRAs are required only at the owner's death, making them an especially useful wealth transfer vehicle for estate planning.[2]

In the case of being the sole beneficiary, a spouse can elect to treat the decedent's Roth IRA as their own thereby delaying distributions until the second spouse's death—potentially benefiting further from tax-free growth.

In the event of children being the beneficiaries of the parents' retirement assets, it may make sense for the adult children to pay for some or all of the tax liability associated with converting their parents Traditional IRA assets into Roth IRA conversion funds by gifting assets to their parents. This approach effectively "pre-pays" the income taxes the children will likely be subject to upon inheritance, but discounted to their present value and market appreciation.

The 2024 federal annual exclusion allows an individual to gift up to $18,000 per year to anyone tax-free. Therefore, a married couple with two married children could receive up to $144,000 in gifted assets in a single tax year (two children and their spouses multiplied by $18,000 equals $72,000 in gifts to each parent).

This accomplishes several things, including:

1) It likely reduces the parents' current or future income tax burden as the Roth IRA assets are not subject to mandatory RMDs.

2) It presents a tax-free and potentially larger inheritance to the children.

3) It affords the children greater control of their inherited tax liability.

For Tax Payers Who Itemize Deductions

An investor may minimize income taxes resulting from a Roth IRA conversion if they possess charitable deductions, carry forwards, investment tax credits, net operating losses or other items that provide ordinary income losses.

Non-spousal beneficiaries will have to take RMDs from the Roth IRA, which may be taken without being taxed (provided that the five-year holding period has been met). Otherwise, only the earnings within the Roth IRA are taxable.[1]

Next Steps

Whether or not a Roth IRA conversion is right for you depends on your personal circumstance. A Roth IRA conversion can be attractive and financially prudent, but the decision may be more nuanced depending on the complexity of your financial situation.

Fisher Investments and a tax advisor can help review the details of your personal financial situation, including long-term goals, tax obligations and possible impact to your estate plans to determine what strategy makes the most sense for you.

Still have questions? Need help getting started?

Fisher Investments has helped tens of thousands—each with unique goals and objectives—evaluate their financial situation. If you want an experienced financial professional to review your portfolio and financial goals, we urge you to call us at **800-568-5082** for a complimentary evaluation.

Sources:

1. https://www.irs.gov/retirement-plans/rollovers-of-after-tax-contributions-in-retirement-plans
2. IRS Publication 590; https://www.irs.gov/publications/p590a; https://www.irs.gov/publications/p590b
3. https://www.cms.gov/newsroom/fact-sheets/2024-medicare-parts-b-premiums-and-deductibles; https://www.medicare.gov/publications/11579-medicare-costs.pdf

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Fisher Investments®

6500 International Pkwy, Ste 2050
Plano, TX 75093 USA

800-568-5082

fisherinvestments.com

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