10 Roth IRA strategies to hedge the risk of higher taxes

The current tax environment and potential for higher tax rates in the future create an opportunity for tax-smart planning.

Since the Tax Cuts and Jobs Act of 2017 (TCJA), tax rates remain relatively low on a historical basis. However, a myriad of factors may suggest higher taxes in the near future. These include the expiration of most tax provisions in 2025, unprecedented federal budget deficits, and potential tax law changes being discussed by lawmakers in Congress.

Investors may want to consider certain strategies to hedge against the risk of higher taxes, including using a Roth IRA conversion.

Roth accounts can offer certain tax advantages, such as providing tax-free income in retirement without required minimum distributions for the account owner. Roth income is also not considered part of the income calculation when determining the taxation of Social Security benefits, or if higher Medicare premiums apply.

Here are 10 Roth IRA strategies to consider:

1. **Determine projected income before year-end as a basis for a partial Roth IRA conversion**
   Calculating projected income may help taxpayers determine the potential tax consequences of converting to a Roth IRA. A good projection can identify your marginal tax bracket, while providing a sense of how much income can be added without creeping into the next, higher tax bracket. Investors may consider a partial Roth conversion that would generate taxable income at a level that would not push them into a higher tax bracket. Lastly, a taxpayer projected to be in one of the highest tax brackets may want to delay converting until the following year.

2. **Wait until year-end approaches to do a Roth IRA conversion**
   As year-end approaches, investors can get a clearer understanding of their projected income and overall tax situation, including the impact of adding additional income with a Roth IRA conversion. This is especially important since, with the repeal of recharacterization beginning in 2018, a Roth conversion cannot be reversed.

3. **Contribute to a non-deductible IRA and, then subsequently, convert to a Roth**
   Certain higher-income taxpayers do not meet the income requirements to contribute to a Roth IRA (income phase-out applies once AGI reaches $138,000 for single filers, $218,000 for married couples filing a joint return). They may consider contributing to a non-deductible IRA and, then subsequently, convert the account to a Roth. Since the IRA was funded with an after-tax contribution, there would be no tax due on that amount when converting. Because of the "pro rata" rule, this strategy may not make sense for those holding other pretax IRA funds. If the investor owns a non-deductible IRA and holds pretax assets in other IRAs, figuring the taxes due upon converting to a Roth IRA becomes more complex. For the purpose of calculating the taxes at conversion, all IRA accounts must be considered in aggregate. Make sure to consult with a tax professional if considering this strategy.

4. **Business owners with net operating losses (NOLs) might consider a Roth conversion**
   Business owners with operating losses for a particular tax year may find that converting traditional IRA funds to a Roth may make sense. If the business owner is structured as a flow-through entity for tax purposes, the net operating loss (NOL) from business operations may be allocated to offset some of the resulting taxable income from a Roth IRA conversion. Rules for calculating and utilizing NOLs are complicated and require expertise from a qualified tax professional. For additional information, refer to IRS publication 536, "Net Operating Losses (NOLs) for Individuals, Estates, and Trusts."

5. **Leverage after-tax retirement plan contributions to create a sizeable Roth position**
Some qualified retirement plans allow voluntary, after-tax contributions into the plan above and beyond normal salary deferrals. For 2023, the limit for overall contributions into a defined contribution plan is $66,000 (not including catch-up contributions). When the plan allows, after-tax assets in a qualified plan can be directly transferred to a Roth IRA under certain conditions. For more information, refer to IRS Notice 2014-54.

6. **Match tax deductions with a Roth IRA conversion**
Consider a Roth conversion during a year when tax deductions may be higher. This may help mitigate the tax cost of the Roth conversion. One way to increase deductions is to lump several years' worth of charitable contributions into a single tax year. Additionally, investors may want to consider a Roth conversion in a tax year when overall income is lower than usual to take advantage of lower tax brackets.

7. **Use life insurance to offset the cost of a Roth conversion for a surviving spouse**
The use of permanent life insurance may help offset the cost of a Roth conversion. For example, a married couple purchases a first-to-die life insurance policy. At the death of the first spouse, the surviving spouse uses the life insurance proceeds to help cover the tax cost of the Roth IRA conversion. This strategy can provide access to tax-free retirement income for the surviving spouse or be used as a tax-free legacy by leaving the Roth IRA to heirs.

8. **Consider Roth conversions before reaching certain milestones**
Timing a Roth IRA conversion is key when it comes to certain age-based milestones, such as retirement or claiming Social Security. For example, converting to a Roth IRA shortly before age 65 may negatively impact Medicare premiums. This is because Medicare considers income from two years prior to enrollment at age 65 when calculating the amount of the premium. Those at higher income levels may face higher premiums.

9. **Capitalize on market downturns as an opportunity for a conversion**
Sharp market downturns may provide a temporary window to convert to a Roth. The lower the value of the investment, the lower the tax cost of the conversion. To the extent the investment position recovers after converting, that market appreciation will be tax-free when distributed from the Roth IRA, assuming requirements are met.

10. **Convert in retirement if leaving IRA funds to higher-income heirs**
The SECURE Act introduced a 10-year rule that generally sets a shorter time limit on the distribution of inherited IRA assets for most non-spouse beneficiaries. This rule could mean a higher tax bill for heirs since the option to stretch distributions based on remaining life expectancy is no longer available, unless an exception applies. A Roth conversion may make sense if account owner(s) are in a relatively low tax bracket in retirement and heirs will likely be in a higher tax bracket.

Importance of expert advice

It's important for investors to work with a tax professional or financial professional who has knowledge of their personal financial situation. A Roth conversion requires a thoughtful decision, since in most cases, taxable income is being generated on the transaction.

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