Morgan Stanley

Roth IRA: A Tax-Smart Retirement Strategy

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The retirement savings that you are working hard to build now will one day become your retirement income. But have you considered the impact that taxes may have on your retirement goals?

One approach to help minimize taxes in retirement is to include a potentially tax-free account, such as a Roth IRA, in your portfolio. With a Roth IRA, contributions are made with after-tax dollars — but qualified withdrawals in retirement can be income tax-free.[1] While income limits may preclude some investors from contributing to a Roth IRA, anyone can convert funds from a Traditional IRA to a Roth IRA.

When you convert to a Roth IRA, you pay income taxes on the taxable amount converted as ordinary income for that year, rather than when you withdraw the funds in retirement. If you think tax rates will be higher during your later years — or that you may be in a higher tax bracket — you may be better off paying taxes on your retirement savings now so you may be able to benefit from tax-free income in retirement. Additionally, a Roth IRA can serve as a source of tax-free income for your heirs (subject to certain conditions).

SEE THE NEXT PAGE to learn more about the benefits of converting to a Roth IRA.

Roth Conversions: Short-and Long-Term Tax Benefits

A Roth conversion may provide compelling benefits; the funds will benefit from tax-deferred growth potential and you may be able to create tax-free income for your retirement. Below are some of the advantages a Roth conversion offers.

A Closer Look at the Benefits of a Roth Conversion

CREATE A SOURCE OF POTENTIAL TAX-FREE RETIREMENT INCOME …

Short-Term Benefits

If you are concerned about future tax increases or you think that your tax liabilities may be higher in retirement, now may be a good time to convert some of your retirement savings — under today's potentially lower income tax rates — into a Roth IRA, where they may never be taxed again. (Note that you should have funds available outside of your retirement account to pay the income tax liability upon conversion, thereby retaining the greatest future benefit of the Roth IRA.)

Long-Term Benefits

Going forward, you may be able to build your tax-free retirement income by making nondeductible annual contributions to a Roth IRA if you are eligible, or by converting some of your retirement savings into a Roth IRA in future years.

MINIMIZE EXPOSURE TO THE MEDICARE TAXES …

A Medicare tax on net investment income applies to high income households (Modified Adjusted Gross Income ("MAGI") exceeding $200,000 for single filers, $250,000 for married filing jointly). Although distributions from IRAs and employer-sponsored qualified retirement plans are not subject to this tax, the taxable amount distributed from such retirement vehicles is taken into account for purposes of determining MAGI and may push you over the MAGI threshold, exposing you to the tax on net investment income. While converting funds to a Roth IRA will increase your MAGI this year, if you believe you might be in a higher tax bracket next year, converting now may help you manage your MAGI threshold and minimize exposure to these taxes.

Qualified withdrawals[1] from Roth IRAs are not included in your gross income and, as a result, do not get taken into account for the purpose of the MAGI thresholds, which may make a Roth IRA attractive to retirees whose other sources of income, such as distributions from Traditional IRAs and employer-sponsored qualified retirement plans, may push them over the MAGI thresholds, exposing them to the surtax.

REDUCE ESTATE TAX EXPOSURE AND CREATE A TAX-FREE LEGACY …

Roth IRAs carry the ancillary benefit of reducing your estate tax exposure, since the funds you use to pay the taxes on the Roth conversion are removed from your estate. This is especially important now, with estate and gift taxes at 40%.

PLEASE NOTE:
A Roth conversion distribution made on or after January 1, 2018, cannot be recharacterized. Please consult your own tax advisor for more information.

A Roth IRA can help you create a potential income tax-free legacy for your heirs. There are no restrictions stating when you must stop contributing and start taking withdrawals during your lifetime, so you can generally leave as much of your money in the account to benefit your heirs as you wish. Certain beneficiaries of Roth IRAs may be eligible to take minimum distributions annually after the death of the owner. If tax rates rise in the future, an income tax-free inheritance is even more valuable because your beneficiaries will receive the income without raising their individual tax brackets.

If eligible, your heirs can extend the tax-deferred growth potential and potential tax-free income benefits of your Roth IRA over each beneficiary's own lifetime, again, without raising their individual tax brackets.

Speak with your Financial Advisor or Private Wealth Advisor to help you determine if a Roth IRA is right for you and to discuss strategies that may minimize the impact of taxes on your portfolio. Consult your own tax/legal advisor before converting to a Roth IRA.

[1] To be a federal income tax-free qualified withdrawal, the distribution must (a) occur after the Roth IRA owner's 5 tax-year holding period, and (b) be made on or after the owner reaches age 59½, due to the owner's death or qualifying disability, or for a qualified first-time homebuyer purchase. The state income tax treatment may differ.

A Roth Conversion may not be right for everyone. There are a number of factors taxpayers should consider before converting, including (but not limited to) whether or not the cost of paying taxes today outweighs the benefit of income tax-free Qualified Distributions in the future. Before converting, taxpayers should consult their tax and legal advisors based on their specific facts and circumstances.

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