Wealth COACH

This is one of the best ways to get tax-free retirement savings

By Jeanne Sahadi, CNN Business
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Of all the tax advantaged ways to save for retirement, the Roth IRA is one of the best.

Though you don't get a tax deduction on your contributions, you can grow, and eventually withdraw the money without paying any taxes on it. Before you hit retirement age, the money is easier to access than most other retirement accounts. And once you're retired you won't be forced to make withdrawals and can grow the money tax-free for as long as you like.

But there is one drawback: You can't save nearly as much annually in a Roth (up to $6,000 this year, or $7,000 if you're 50 or older) as you can in a 401(k) (up to $19,500 pre-tax or $26,000 for those 50 and over). Plus, those who earn above certain thresholds aren't eligible to make Roth contributions.

You can get around all those limits, however -- even if you're a high earner -- if you choose to convert some of your tax-deferred savings from a 401(k) or traditional IRA into a Roth.

With conversions you might owe income taxes on the savings you transfer, but from then on it's all tax free -- the earnings on that money and the withdrawals you make from the account in the future.

Who should convert?

For all the advantages of a Roth, the decision to convert existing savings isn't dead simple. A lot depends on your income needs and income sources in retirement, said California-based certified public accountant John Schultz. "It's a complex analysis."

Still, a conversion may be worth considering if you fall into one of at least three categories, according to New Jersey-based CPA Joseph H. Doerrer.

1. You expect to be in a higher tax bracket in retirement than you are today. Do you believe that federal income tax rates are likely to be higher when you retire? If so, paying tax on the money you convert today might be better than waiting to pay tax on it in retirement.

2. Your current income is much lower than usual. Converting retirement savings to a Roth when you're not bringing in as much money as you normally do will result in a lower tax bill than if you waited to convert in a year when you're in a higher tax bracket.

3. You're already high net worth and want to bequeath the money to your children. Putting it in a Roth lets it grow tax-free until you die, and then your kids will have 10 years after that to empty the account.

to help you make calculations under various scenarios.

A backdoor into contributing to a Roth

If your modified adjusted gross income in 2021 is at least $140,000 ($208,000 if you're married) you are not allowed to make annual contributions to a Roth.

But anyone -- including high earners -- may convert existing retirement savings into a Roth.

So if you make too much to contribute directly, you can still create a "backdoor Roth," Doerrer said, by making a non-deductible contribution to a traditional IRA, then quickly converting those savings into a Roth.

By doing that, you also will avoid paying taxes on any gains on your contribution because the money will not have time to grow before you make the conversion.

But be aware that if you have other traditional IRA savings, a pro rata rule will be applied across all your IRA savings to determine how much of your non-deductible IRA contribution will be treated as tax free when you convert it. In all likelihood, Doerrer said, "only a portion of what you convert would be nontaxable."

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Keep the tax bite during conversion to a minimum

For anyone converting savings that have grown over time to a Roth, keep in mind the amount you convert will be added to your annual taxable income. Consequently, it will bump up your tax bill for that year.

And if you convert a very large sum all at once, it could push you into a higher federal tax bracket.

So you may minimize your tax bill if instead you opt to convert the money in smaller chunks over a few years, Schultz noted.

Either way, be sure you have enough liquid funds on hand to pay the taxes you'll owe on the conversion.

Tax-free savings through your employer

Another option for tax-free retirement savings is a Roth 401(k).

Three quarters of employers that offer a 401(k) plan allow employees to make Roth contributions, according to the Plan Sponsor Council of America.

Unlike a Roth IRA, there is no income limit on who may make contributions to a Roth 401(k).

The federal contribution limits to a Roth 401(k) are the same as a traditional 401(k) -- $19,500 for those under 50. That's the combined limit for your contributions to your employer plan, regardless of which types of 401(k) accounts you put

And employers may even offer a matching contribution for your Roth 401(k), but the match will be made on a pre-tax basis and put into a traditional 401(k) account, Schultz said. "So the employee would then have two accounts."

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Also, unlike with a Roth IRA, federal rules require that you start taking distributions from a Roth 401(k) no later than age 72. But that shouldn't be an issue if you decide to roll your Roth 401(k) over into a Roth IRA when you leave the company.

With any workplace savings plan, however, be sure to check the specific rules your employer sets since they may differ from company to company.