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TO ROTH, OR NOT TO ROTH?

In our April newsletter there was a brief mention of Roth conversions and how 2020 may offer a unique opportunity to implement this strategy for some clients. This month we will look to provide a bit more detail on this topic.

Roth IRA Conversion Defined: A Roth IRA conversion involves transferring retirement funds from a pre-tax traditional IRA, SEP IRA, SIMPLE IRA, 401(k) or 403(b) into a tax-exempt Roth IRA account. Income taxes must be paid on the converted funds in the year of the conversion. Thereafter, the funds in the Roth IRA are afforded tax-free growth for the balance of the owner's life (and their spouse's life). Generally, Roth conversions make sense if one believes that the tax impact of future withdrawals from pre-tax accounts will be more punitive than paying those taxes now. Up until 2010, Roth IRA conversions were limited to those who had income of $100,000 or less. This income limit has since been lifted, which has provided some investors with additional flexibility for tax planning purposes.

Historical Argument for Pre-Tax Contributions: Pre-tax retirement account contributions offer savers a deduction in the year that they are made, lowering one's current taxable income. Those funds are allowed to grow tax-deferred and distributions are taxed as income in retirement. Conceptually this makes sense as workers can deduct their contributions while they are working (often while in a higher tax bracket) and withdraw the money in the future when they are retired (often while in a lower tax bracket). This is essentially flipped for Roth accounts, which are funded with after-tax dollars and are afforded tax-free growth thereafter.

When Pre-Tax Accounts Cause Headaches: While pre-tax IRA, 401(k) and 403(b) accounts offer tax-deductible contributions and tax-deferred growth, the tax bill ultimately comes due when distributions are made in retirement. That tax bill can be significant enough to where retirees who have consistently saved pre-tax retirement dollars for their whole career end up with income in their later years that is equal to or higher than when they were working.

For retirees who have reached age 70 ½ (if born before July 1, 1949) or 72 (if born after June 30, 1949), have assets in a pre-tax retirement accounts and do not meet the 'still working exception', they are required to take out a predetermined percentage of those assets annually and pay the resulting tax. The IRS requires distributions to start at about 3.5% of the account annually, with that percentage increasing slightly every year. By age 90, the required distribution rate is almost 9% of the account value. It is not uncommon for us to see older clients with several hundred thousand dollars of taxable IRA distribution income in their later years.

Planning for Beneficiaries: We've also seen situations where couples that are married and filing jointly have significant pre-tax assets and the death of one spouse leaves all of those pre-tax assets to the surviving spouse. If required minimum distributions from pre-tax retirement accounts are a material part of that couple's income, the survivor can be left with the same amount of income, but starts to pay taxes as a single filer. Single filer tax brackets are much more compressed than married filing jointly brackets, which can push the survivor into a higher tax rate. If that couple is able to covert a portion of their pre-tax assets to Roth IRA assets early on in retirement, it could result in significant tax savings for the survivor.

Looking beyond the lifetime of a surviving spouse, due to the passage of the SECURE Act in December of 2019, most non-spouse beneficiaries who inherit pre-tax retirement accounts in 2020 or later are now required to fully distribute those accounts and pay the resulting

tax by the end of the tenth year following the original owner's date of death. This is less tax efficient than the 'stretch IRA' provisions that used to allow non-spousal retirement account beneficiaries to distribute inherited pre-tax assets and pay the resulting tax over their entire remaining lifetime. All else equal, it is now less tax efficient for most non-spouse beneficiaries to inherit pre-tax retirement assets.

Why 2020 is Unique: The CARES Act, which was recently signed into law has relaxed all required minimum distributions from retirement accounts for 2020. Anyone who was planning on having a taxable required minimum distribution in 2020 can forgo that distribution altogether, thereby lowering their income for 2020. On the other hand, anyone in this situation who does not need the proceeds from the forgone required distribution could take any or all of that distribution, pay the resulting tax, and move the balance into a Roth IRA account. This is something that could not have been done with a required distribution prior to the relaxation via the CARES Act.

Roth IRA conversions can also make more sense in years when asset prices are depressed. The idea here is to distribute IRA assets, pay the resulting income tax at the current valuation and move the proceeds into a Roth IRA. Any recovery in prices and all future appreciation will take place in a tax-free account.

Last but not least, the government spending response to the COVID-19 outbreak must be considered from a fiscal point of view as we look into the future. Our country is now looking at significantly higher near-term government deficits, which eventually have to be paid for. All else equal, higher deficits may mean higher tax rates in the future. As a result, paying taxes at one's current rate in order to get assets into a tax-free environment going forward may make more sense today than it did just a few months ago.

While 2020 is unique in that required minimum distributions have been relaxed, there are also situations where Roth conversions can make sense for clients that have yet to reach their required beginning date for distributions. The most common situation that we see involves an early retiree with sizable pre-tax accounts who may have as many as 10+ years of relatively low income prior to the start of their required distributions at age 72. Those low income early retirement years can be ideal for Roth IRA conversions.

When Converting May Not Make Sense: Every plan is unique and there are many situations where converting pre-tax assets into a Roth IRA may not make sense. These situations include, but are not limited to:

- Phasing out of Affordable Care Act healthcare subsidies for those who do not have employer healthcare and are not yet on Medicare.
- Increasing income to a level where Medicare Part B premiums start to go up.
- Negatively affecting income-based educational financial aid for offspring.
- Subjecting Social Security income to a higher level of taxation for those who are collecting Social Security and have relatively low income.

Given all of the moving parts and variables that need to be considered when it comes to Roth conversions, everyone's plan must be considered on a case-by-case basis.

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