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Time to Revisit Roth Conversions: 4 Factors to Consider and 6 Suggestions

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Prior to the tax increases in 2011 we posted an article titled, “Converting a Traditional IRA to a Roth: Clues to Resolving a Confusing Conundrum.” At that time, tax rates were scheduled to increase in 2011 with the highest marginal rate increasing from 35% to 39.6% (not counting the 3.8% tax on investment income). In the category of “everything old is new again”, President Biden’s proposed tax plan would increase the top rate from 37% back to 39.6%. **The President’s plan provides incentive to reconsider a Roth conversion.**

The Small Business Jobs Act of 2010 allowed retirement plan participants to make in-plan Roth rollovers of distributable amounts, and the Taxpayer Relief Act of 2012 extended the availability of in-plan Roth rollovers to amounts not otherwise distributable from qualified plans (e.g. 401(k) plans). The in-plan Roth rollover conversion must be a permitted feature in the plan document. The discussion is framed in the context of traditional IRA conversions, but the analysis extends to in-plan Roth rollover.

In the scheme of retirement, estate and financial planning, evaluating the conversion of a traditional IRA that is subject to income tax at the time of distribution to a Roth IRA, from which distributions are income tax free, remains a challenging exercise. However, it is worth the effort because making the right decision now may create a significant cash benefit in the future for the IRA owner and beneficiaries.

Background

The traditional IRA is funded with tax deductible contributions and the withdrawals are taxed to the owner/beneficiary as ordinary income. With limited exceptions, withdrawals prior to age 59½ are subject to a 10% penalty and distributions are subject to the required minimum distribution rules so distributions must commence no later than the owner attaining age 72.

The Roth IRA or plan account is funded with after?tax contributions. After the owner attains age 59½ and the Roth IRA has been open for five (5) years, withdrawals of all amounts are income tax and penalty free. In addition, during the owner’s lifetime, the Roth IRA is not subject to the required lifetime minimum distribution rules.

The Conundrum

The challenging question of whether to convert from traditional to Roth and the factors to consider have not changed over the past eleven (11) years. Unfortunately, the decision involves many unknown factors such as: future tax rates that will be in effect at the time of distribution and the length of time funds will be withdrawn.

Most significantly, the opportunity to convert comes at the cost of paying income tax at the present time on the amount to be converted. This is the actual and philosophical obstacle that is the greatest challenge in the conversion conundrum: accelerating the payment of income tax flies in the face of the fundamental tax principle of deferral. Conventional wisdom is to defer taxes on the IRA investment until retirement, which is a time when most people are in a lower income tax bracket. Into the mix of unknowns, add the SECURE Act’s

elimination of the stretch (or lifetime) distribution option for most non-spouse beneficiaries and replacing it with a ten (10) year distribution rule.

At a minimum, to evaluate a possible Roth conversion, the following four factors should be considered:

1. Owner/Participant's age at conversion and estimated age at retirement (or default to age 72 because the traditional IRA is subject to the lifetime required minimum distribution rules);
2. Estimated rate of return on investments;
3. Current income tax rate at the time of conversion and the estimated income tax rate at the time of withdrawal; and
4. The duration over which IRA withdrawals are anticipated (e.g. life expectancy plus ten (10) years for children).

At the time of conversion the IRA owner's age and current marginal income tax rates will be known. We cannot predict what will happen with President Biden's tax proposal let alone the tax rates in another 10 or 20 years. Given the trillions of dollars of new spending proposals (that we know of), it seems reasonable to anticipate higher taxes in the future.

Faced with many unknowns and contradiction of conventional wisdom, how should an owner/participant proceed?

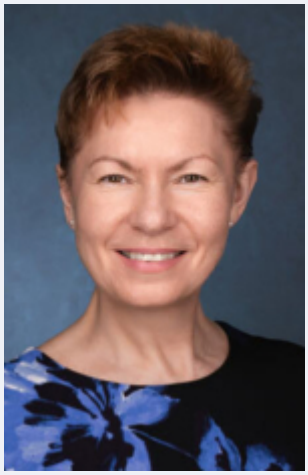
Following are six suggestions for your consideration:

1. Calculators. "Roth Conversion Calculator" inserted in the search engine of choice will yield many online tools that allow comparison of different assumptions about future tax rates, earnings and distribution timeline. Be careful not to make the conversion decision a purely mathematical exercise. If there is a likelihood that the funds will be needed within five (5) years of conversion, the benefit will be lost.
2. Deferral Duration. The longer the time available for tax free compounding, the greater the benefit. The calculators will confirm the power of compounding.
3. Consider Other Taxable Income In Retirement. If the Owner/Participant will continue to receive wage or consulting income or participate in other employer sponsored retirement plans that will pay a taxable benefit during retirement, these revenue sources, combined with traditional IRA distributions, may push the Owner/Participant into a higher tax bracket in retirement.
4. Tax Opportunities. If the owner/Participant has operating losses or other tax losses at the time of conversion these may offset the tax on conversion. Younger individuals with a longer time horizon to retirement, may consider Roth contributions to a Roth IRA or Roth 401(k) and pay the tax a little at a time year-over-year. This avoids the big tax liability associated with a sizable conversion in later years.
5. Estate Planning. The Roth is an asset taxable in the owner's estate. However, avoiding required lifetime minimum distributions affords the Owner/Participant the opportunity to hold assets in the Roth, compounding tax free, while exhausting other taxable income producing assets. At death, the spousal rollover rules apply and distributions to non-spouse beneficiaries must be made within ten (10) years after the owner's death. The beneficiaries receive the benefit of income tax free distributions. This may alleviate some of the loss of the stretch distributions benefit.
6. Hedge. There is no requirement that the entire IRA or plan account be converted. Beginning in 2015, only one rollover from an IRA to another (or the same) IRA in any 12-month period is permitted. Since conversion is considered a rollover, the Owner/Participant can do one conversion per year. (Announcement 2014-15 and Announcement 2014-32). Partial account conversions may be made to meet individual planning objectives. Consider mixing and matching deferrals between traditional pre-tax and Roth IRA assets. This approach may take the sting out of the income tax payment at conversion.

Conclusion

If higher tax rates are expected to apply during retirement years or the Owner/Participant is younger and expects income and tax rates will increase take the time to consider a Roth conversion or Roth

deferrals. On-line calculators are readily available as a preliminary step in the analysis that can be followed up with financial and estate planning advisors.



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