The Wealth Report

With the prospect of rising taxes, this may be the last year for quite some time where it makes sense to convert assets from a 401(k) or a traditional IRA to a Roth. But is it the smart move?

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2021: LAST CALL FOR ROTH IRA CONVERSIONS?

Overview

Are you thinking strategically about the possibility of higher taxes and their effect on your retirement assets? With Democrats controlling the White House and House, as well as having a fragile majority control of the Senate, higher taxes are expected in the near future for higher-earning and high net worth Americans. However, tax reform likely won't go into effect before 2022, making this a key year to seriously consider whether a Roth IRA conversion is a good idea for your portfolio.

A Roth IRA conversion is the strategy of transferring assets from a tax-deferred retirement account to a tax-free retirement account. On the surface, the steps appear to be simple:

1. Open a Roth IRA.
2. Transfer 401(k) or traditional IRA assets to the Roth IRA.
3. Pay income taxes on the assets transferred.

In reality, however, this strategy is anything but simple. Let's start with some of the more complex rules.

Roth IRA Conversion Rules

There are very precise rules that must be followed to maximize the benefits of converting a 401(k) or traditional IRA to a Roth. You (or your financial advisor) must make sure the trustees of both the origination and the destination accounts understand that you are making a Roth IRA conversion.

- If you are converting after age 72, you must take your RMD for the year before converting the rest of the assets.

- If you personally receive the origination account funds, you must deposit them into the new Roth IRA within 60 days of the distribution. Otherwise, it's not considered a rollover conversion, but strictly a distribution. This means it may be subject to an additional 10% penalty tax if the account owner is younger than 59 ½. The easiest way to conduct the conversion is to have the trustee of the original account send the assets directly to the trustee of the Roth IRA.

- While pre-tax contributions and all gains are subject to regular income tax rates, the tax calculation is more complex if there are

any after-tax contributions mixed in the original account. In this case, the amount converted is taxed as a percentage of the after-tax contributions to the pre-tax contributions and earnings. For example, say you had made a $7,000 after-tax contribution to the same account that had pre-tax contributions and earnings valued at $100,000. In this scenario, approximately 93.5% of the amount converted would be subject to income taxes ($100,000 divided by $107,000).[1]
(Note that if a taxpayer is converting an employer plan account with pre- and post-tax dollars, and if the account is being completely liquidated, there is a possibility of a tax-free conversion of just the after-tax monies. See IRS Notice 2014-54 for more information.)

• You may want to conduct a Roth conversion over several years. By transferring small portions at a time, you can avoid tipping over into a higher tax bracket and having to pay excess taxes all in one year.

• Once the conversion is complete, an investor younger than 59½ who accesses the converted amount within five years of the conversion will have to pay an addtional 10 percent early withdrawal penalty. If earnings on the converted amount are accessed, they are subject to both income tax and the extra 10 percent tax. Once five years have passed since the conversion, the extra 10 percent tax on the converted amount no longer applies.

Scenarios That Make Sense To Convert

Why would you convert assets to a Roth IRA? Here are a few scenarios in which this strategy can be advantageous.[2]

"Gap" Years
Gap years are those when the individual is taking time off between jobs, or is retired but hasn't started taking retirement plan RMDs or Social Security yet. Because her earned income has dropped, she may be in a lower tax bracket, so she's a prime candidate for a Roth IRA conversion.

Younger Person With a Smaller 401(k)
The younger the individual, the longer his money can grow tax-free in a Roth IRA. If he's ready to jump ship from a corporate job to start his own entrepreneurial venture, it may be a good time to convert his employer-sponsored retirement plan before too many assets build up and his tax burden grows. As an added bonus, after five years, he would be able to tap that money tax- and penalty-free to expand his business, or for any other reason.

Asset-Rich, Income-Poor
With many jobs lost during the pandemic, some people are living off their savings. For those who have ample assets, this also may be a good time to convert portions of a 401(k) to a Roth IRA. Bear in mind that the individual considering a conversion should have enough savings to pay taxes on the converted assets, but her taxes should be lower since she's

out of a job. While she may not be able to access those converted assets penalty-free for another five years, this strategy can create a separate emergency savings account for the future.

Scenarios That Don't Make Sense To Convert

While it may be tempting to convert retirement assets to a Roth while tax rates are low, there are several scenarios in which this would not be a good idea.

Early Retirement Income
Since there's a five-year delay before a person under age 59 ½ can access newly converted Roth funds penalty-free, this strategy may not be ideal for an early retiree who needs immediate income.[3]

Lower Tax Bracket in Retirement
If the individual expects to be in a lower tax bracket during retirement, he might as well wait and pay taxes on distributions as he takes them at that point. Also consider that many retirees relocate to states that have lower or zero state income taxes, such as Florida. By waiting until he retires, the individual can avoid paying state income taxes on retirement distributions altogether.[4]

Higher Tax Bracket in Retirement
Even if the individual is in a lower tax bracket during retirement, converting assets could bump her into a higher tax bracket. Furthermore, the higher income level that year could cause her premiums to rise for Medicare Part B benefits, and may subject a higher portion of her Social Security benefit to taxes.[5]

Inheritance Planning
A non-spousal IRA beneficiary must take full distribution of 401(k), traditional IRA or Roth IRA assets within 10 years of inheriting the account. The question to consider is whether those assets would be better off converted while the account owner is alive at the owner's tax rate, or at the beneficiary's tax rate. If the beneficiary will likely remain in a lower tax bracket, then the owner might as well leave assets where they are rather than using up more of his estate's assets to pay the income tax on the conversion.[6]

Charitable Estate Planning
If the person's goal is to leave retirement account assets to a charity, there's no point in converting them to a Roth IRA and paying the taxes. A qualified charity is exempt from the tax obligation on donations.[7]

No Cash To Pay Taxes
If the individual doesn't have other cash available to pay the taxes on a Roth IRA conversion, it may not be worth it. Consider a 401(k) account valued at $100,000. When converted, the person may owe $24,000 in additional taxes that year. If she doesn't have ready cash and must use money from the original account to pay the taxes, her Roth IRA would

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then have only $76,000. Perhaps it might have been better to keep the $100,000 growing tax-deferred than start at $76,000 and hope to make up the lost earnings by the time she needs to take withdrawals.[8]

"Doing a Roth IRA conversion when asset values in a client's traditional IRA are low can provide them with 'more bang for their conversion buck.'"[9]

Roth IRA Conversion Benefits

It may seem as though there are fewer pros than cons to a Roth IRA conversion, but the reality is that it's a very good strategy for some people and a wasteful one for others. It's important to have a frank discussion with an experienced professional to understand which category you may fall under. After all, there are some very strong benefits to making the conversion.[10]

Tax-Free Income
By converting assets while you are still working, you can pay taxes with current income and allow the Roth IRA to continue growing tax-free. Once retired, all the money distributed from the Roth will be tax-free. This may be important if, once you retire, you have income flowing in from multiple income sources (e.g., 401(k), IRA, pension, brokerage account and Social Security), as you could end up in a higher tax bracket in retirement than when you were working.

Tax Diversification
You may decide to convert only a portion of your retirement account into a Roth IRA. This would minimize his added current tax liability on a conversion, while also reducing some of your tax burden in retirement.

Eliminate RMDs
If you plan to work into your 70s, or don't need the income once you turn age 72, you can avoid having to take RMDs from a 401(k) or traditional IRA by converting them to a Roth, which does not require RMDs. This way the full account balance has the opportunity to continue growing for your spouse or heirs.

Final Thoughts

When considering a Roth IRA conversion, evaluate the potential break-even point in which tax-free withdrawals and the ability to avoid RMDs outweigh the burden of paying taxes at the time of conversion. The answer may lie in comparing current tax status to what the future tax status might look like.

Like any financial strategy, the decision to conduct a Roth IRA conversion is based on individual circumstances, such as age, portfolio diversity, long-term goals, tax bracket and the tax status of future heirs. It may be right for some but not for others, so speak with your financial advisor as well as a qualified tax professional to help determine if 2021 is the right time to make this move.

[1] Roger Wohlner. ThinkAdvisor. Jan. 5, 2021. "Roth IRA Conversions: What Advisors Need to Know." https://www.thinkadvisor.com/2021/01/05/roth-ira-conversions-what-advisors-need-to-know/. Accessed Feb. 15, 2021.
[2] Jane Meacham. Financial Advisor. Feb. 10, 2021. "Roth Conversions Remain Timely Ahead Of Likely Tax Increases." https://www.fa-mag.com/news/roth-conversions-remain-timely-ahead-of-likely-tax-increases-60301.html. Accessed Feb. 15, 2021.
[3] Bud Boland and Patricia Sklar. Kiplinger. Oct. 27, 2020. "6 Reasons You Should NOT Do a Roth Conversion." https://www.kiplinger.com/retirement/retirement-plans/roth-iras/601626/6-reasons-you-should-not-do-a-roth-conversion. Accessed Feb. 15, 2021.
[4] Ibid.
[5] Roger Wohlner. ThinkAdvisor. Jan. 5, 2021. "Roth IRA Conversions: What Advisors Need to Know." https://www.thinkadvisor.com/2021/01/05/roth-ira-conversions-what-advisors-need-to-know/. Accessed Feb. 15, 2021.
6 Bud Boland and Patricia Sklar. Kiplinger. Oct. 27, 2020. "6 Reasons You Should NOT Do a Roth Conversion." https://www.kiplinger.com/retirement/retirement-plans/roth-iras/601626/6-reasons-you-should-not-do-a-roth-conversion. Accessed Feb. 15, 2021.
[7] Ibid.
[8] Ibid.
[9] Roger Wohlner. ThinkAdvisor. Jan. 5, 2021. "Roth IRA Conversions: What Advisors Need to Know." https://www.thinkadvisor.com/2021/01/05/roth-ira-conversions-what-advisors-need-to-know/. Accessed Feb. 15, 2021.
[10] Ibid.