It is common practice for us to speak with our clients about Roth IRA conversions, and whether implementing this strategy may make sense from a long term perspective. A number of factors have come into play recently which have made it a strategy that is all the more compelling to consider for our clients.

What is a Roth IRA Conversion?

A Roth IRA conversion is when you take all, or a portion, of your traditional IRA or 401(k) balance and transfer it into a Roth IRA account. The amount that is transferred to the Roth IRA is taxable to the IRA owner as ordinary income in the year of the conversion.

What are the benefits?

The Roth IRA account will grow tax free, and withdrawals made from a Roth IRA are also tax free. In addition, in contrast to Traditional IRAs, Roth IRAs are not subject to Required Minimum Distributions. Given their tax-free nature and that there are no Required Minimum Distributions during the owner's lifetime, a Roth IRA can be a great tool to leverage in estate planning because you can allow the funds to grow tax free for longer, and have flexibility as to when you draw on those assets. When an heir inherits a Roth IRA, they will be required to take distributions, but the distributions to them are also tax free.

What are the relevant considerations?

The most important individual financial factors to consider when contemplating a Roth IRA conversion are your current income and income tax levels as well as projected future income and income tax levels. In doing a Roth conversion, you are paying tax now, with the expectation that the funds will grow significantly and that the taxes paid on that higher total future value would be significantly more than the tax you would be paying today. The expectation might also be that your current tax rate is lower than it will be in the future, specifically around age 72, when you would be expected to start taking required minimum distributions from your traditional IRA. Ideally, if we knew with certainty both current and future levels, we would easily be able to evaluate whether it is more beneficial to pay the tax now or to pay it in the future. Since we do not know for certain what future tax rates will be, we can only consider your current income and tax levels, and make assumptions about future levels.

Why is now a good time?

There are numerous reasons why we believe this might be a very compelling time to consider a Roth conversion. Two primary reasons have to do with policies implemented over the past few months.

The first being the SECURE Act which was passed towards the latter part of last year and stipulates that IRAs that are inherited must now be distributed over a 10-year period. Prior to the passing of the SECURE Act, a beneficiary would have been able to inherit an IRA and take distributions over the duration of their lifetime. The ability for a beneficiary to take distributions over their lifetime would result in significantly lower required distributions annually, and thusly less of a tax impact. Having to now take those distributions over a compressed 10-year period, could result in a significant tax bill for the inheritor. By converting all, or a portion of your pre-tax IRA assets to a Roth IRA, you are paying the tax now in order to allow those assets to continue to grow tax free in the future, as well as to allow your beneficiaries to take distributions from the inherited Roth IRA without having their inheritance eroded by taxes.

The second policy factor is that as part of the recently passed CARES Act, those who were subject to RMDs in 2020 are no longer required to take those distributions. This allows for more flexibility in 2020 to manage your income levels when choosing to make a Roth conversion.

Another reason it may be advantageous to consider a Roth conversion at present is that we have seen competitive tax rates and tax cuts in the past few years. Given the amount of stimulus the government is providing during this time to help stimulate the economy and support the health care system, there will, at some point, come a time where that needs to be paid back. It is not unlikely that this will be done, at least in some part, by way of higher taxes in the future. Given that so much of evaluating whether or not a Roth conversion may be advantageous for you involves assessing your current tax situation vs. what it may be in the future, this may be an opportune time to capitalize on current tax rates.

Finally, another important point to consider when considering a Roth conversion is market fluctuation. Short-term volatility in the markets can present opportunities from a planning perspective, and it is our job to identify ways to take advantage of those opportunities to help to position you in a manner that helps you accomplish your long term goals. In many cases, taking advantage of lower market values to complete a Roth conversion is a way to get a discount on a strategy that would have been beneficial either way. If you were to convert your IRA at a time when the assets are at depressed levels, you would be paying tax on the lower value of the assets. Over the long term, however, we expect that values will return to and exceed prior values, so you would be paying less tax to convert the same assets that will likely be at a significantly higher value in the future.

While there are certainly situations where converting an IRA into a Roth at this time may not make sense, we think it is something all of our clients should be considering. Please reach out to us to discuss further so we can work together to evaluate whether completing a Roth conversion may make sense for you.

We hope you are staying healthy and safe during these uncertain times.

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