December 2020

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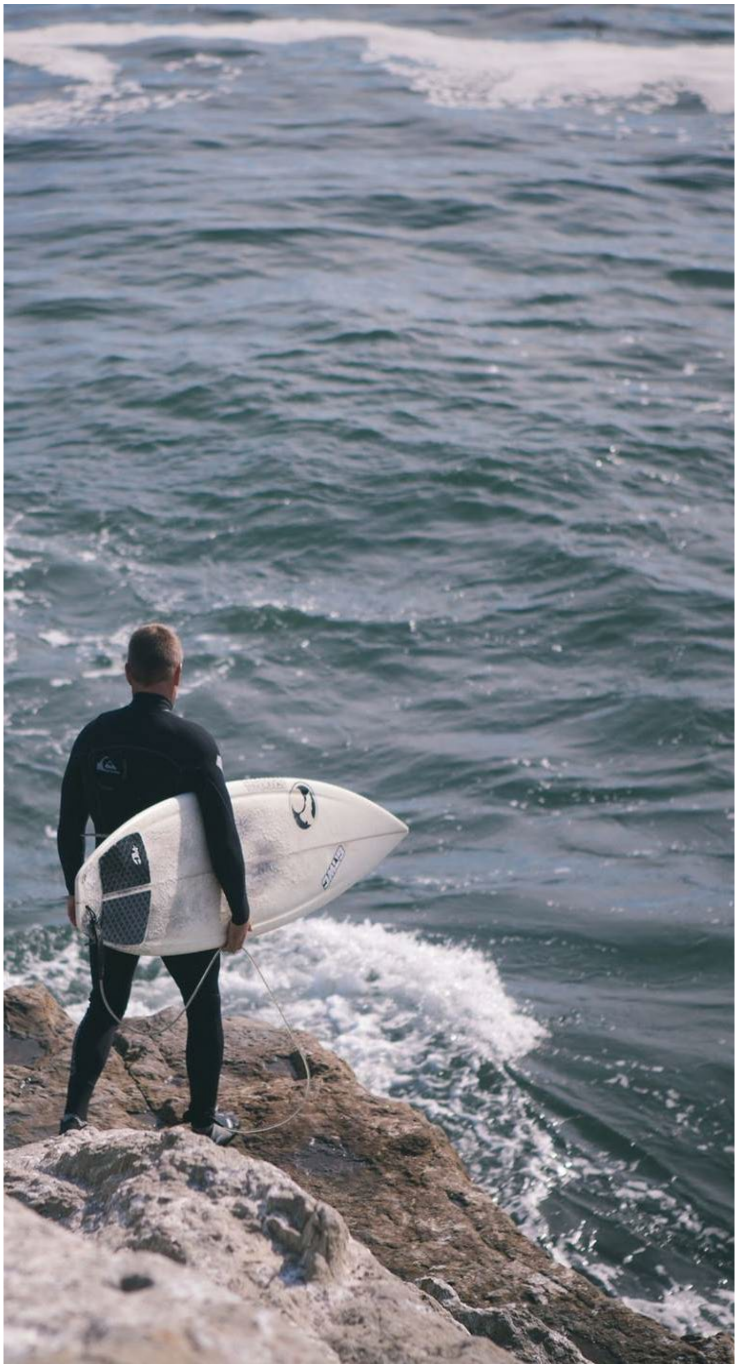
Roth IRA Conversion



Does A Roth IRA Conversion Make Sense?

A provision of the SECURE Act eliminated the opportunity to 'stretch' the taxation of traditional IRAs to most non-spousal beneficiaries[1]. With this change, Roth IRA conversions have gained renewed attention in financial planning circles. Whether or not a conversion is the right choice depends on each client's individual facts and assumptions. Clients should consult their wealth and tax advisors and run calculations using appropriate input assumptions to determine whether it is right for them.

What is a Roth IRA Conversion?

A conversion involves the transfer of part or the whole of an existing traditional IRA into a Roth IRA account. The balance transferred into the Roth account becomes taxable income for federal, and potentially, state income taxes in the year in which the conversion occurs. However, the 10% Additional Tax for Early Distribution penalty does NOT apply.

Roth IRAs have several advantages over traditional IRAs. Contributions to a Roth can be withdrawn at any time without tax or penalty because they have already been taxed. Furthermore, the earnings grow tax-free so long as they are left in the Roth account for at least five years from the date of first contributions or until age 59 ½, whichever is longer. Earnings of a traditional IRA grow tax-deferred until they are withdrawn and then are taxed. Finally, Roth IRAs, unlike traditional IRAs, are not subject to the Required Minimum Distribution Rules beginning at age 72. This feature gives Roth IRA owners and beneficiaries the opportunity to keep assets growing on a tax advantaged basis longer, especially now that the ability to 'stretch' the taxation of traditional IRAs has been impacted by the SECURE Act.

[1]Additional information on the SECURE Act can be found in our March Publication here.

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What Factors Should Be Considered In Making A Conversion Decision?

When a conversion is made, the converted balance is taxed at the current marginal tax rates. Clients should consider the impact of future tax rates on traditional IRA distributions if a conversion is not made. Roth conversions make more sense when we believe tax rates on future distributions will be higher than they are currently. For those in the top marginal tax bracket today, it should be noted that the incoming Biden administration's proposed income tax policy would increase the top marginal bracket for those making more than $400,000 per year (married, filing joint return). For those who are not in the top marginal bracket, making partial conversions over time to keep from moving into higher tax brackets should be considered.

Consideration should also be given to the effects a conversion can have on other financial areas. For example, future traditional IRA distributions would increase taxable income and potentially make more of one's Social Security benefits taxable while also potentially increasing Medicare premiums. Additionally, the time until someone needs to take IRA distributions for cashflow purposes or because of Required Minimum Distributions (traditional IRAs) is a paramount consideration. The longer one can let the converted balance grow, the more successful the conversion will be. As such, when doing a conversion, one should use assets other than the IRA to pay the tax on the converted balance. Generally, using the IRA assets to pay the tax will significantly impede the successful outcome. Those who are already receiving distributions, or who will need distributions shortly for living purposes, will find it harder to justify converting to a Roth mathematically.

Finally, unique for the 2020 tax year, the CARES Act increased the percentage of charitable contributions that could be deducted in the current year to 100% of adjustable gross income if made in cash directly to charities (not Donor Advised Funds). For those who are exceptionally charitably inclined, doing a Roth conversion in 2020 would provide for an expanded opportunity to accomplish two goals at the same time: 1) get a larger charitable contribution deduction in 2020, and 2) pay no federal income tax on the Roth IRA conversion.

Those considering a conversion should examine the feasibility based on their individual situation. Many Roth IRA conversion calculators exist, which allow clients and advisors to input assumptions to understand better how various factors impact the situation and outcome of a conversion.