Roth IRA Conversions: Why Now

By Kristi Mathisen

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It may seem counterintuitive: Because of the drop in stock prices in 2020 — and hence IRA account balances — this year could be a good time to convert at least a portion of an existing IRA into a Roth IRA. The goal: an additional source of tax-free income, especially if you are recently retired or will retire soon.

Since 2010, conversion of an IRA to a Roth IRA has been allowed for people at any income level. The catch: you will owe income taxes on the amount converted as if you had received it in cash. Assuming you are willing and able to pay the extra taxes, why would you want to do that in what could be a down year for the markets? Let's start with the ultimate goal, which is to get the two main benefits of a Roth IRA:

- **Tax-free growth AND tax-free withdrawals.** As with any IRA, assets in a Roth IRA grow tax-free. However, if you hold a Roth for five years after funding, all withdrawals after that are tax-free. (There is a 10% penalty on withdrawals before age 59 ½).
- **A powerful estate planning tool.** For one, there are no Required Minimum Distributions (RMDs) on Roth IRAs when you reach age 72. So money can stay in the account as long as you want. After you are gone, your heirs can inherit your Roth IRA, retaining the account and its tax-free growth for up to 10 years. At any time, they can make tax-free withdrawals, if the Roth account was open for at least five years before they inherited it.

Convert and Conquer

There are four main reasons you might want to pay income taxes on a Roth conversion now, even though the full benefits will not materialize for five more years:

	Tax-Deductible Contributions	Tax-Free Account Growth	Tax-Free Withdrawals*	NO Required Annual Withdrawals Starting at age 72
Roth IRA	X	✓	✓ Tax-free 5 years after 1st deposit	✓
Pre-tax IRA, SEP IRA, 401(k)	✓	✓	Income tax on all withdrawals	X
After-tax IRA (contributions were not tax deductible)	X	✓	Taxes on capital gains and investment income and cannot write off capital losses	X
Taxable accounts	X	X	Taxes on capital gains and investment income but can write off capital losses	X

*Most withdrawals from IRAs and qualified retirement plans before age 59 1/2 are subject to early withdrawal penalties, except for certain reasons, including medical emergencies.

#1. Take advantage of lower stock prices. Because of recent stock market volatility, the balance in your IRA accounts may well be lower than it has been in the past three years. This means the Roth conversion is "on sale." You would be converting a lower amount to a Roth IRA, which means a lower income tax hit. Just as important: the amount converted can then grow tax-free inside your Roth IRA as the markets eventually recover, and you can access that growth tax-free in the future, assuming you meet the five-year holding requirement.

#2. Control what you report as income. You can convert just a portion of an existing IRA, not the entire account. This allows you to control how much income tax you will pay in any one year. If you know that your taxable income will be lower this year or next (operating losses on a business, charitable contribution carryovers, etc.), you should consider a Roth conversion – assuming you have money available to pay the extra taxes. Note: avoid paying the extra taxes with IRA money, since that would magnify the tax cost of the conversion – basically, you would be paying taxes on the amount needed for taxes.

#3. Take advantage of relatively low tax rates, especially for upper-income Americans. Tax brackets have widened due to the 2017 Tax Act, so currently you can fit in more income and stay in the same tax bracket. Since the US is now facing much higher federal budget deficits plus the Social Security funding shortfall, it is quite possible that tax rates could rise in the future, especially for higher-income households. And not just income taxes, but also federal and state estate taxes.

2020 Income Tax Rates

Rate	Taxable Income Single
37%	> $518,400
35%	$207,350 — $518,400
32%	$163,301 — $207,350
24%	$85,526 — $163,300
22%	$40,126 — $85,525
12%	$9,876 — $40,125
10%	Up to $9,875

Rate	Taxable Income Married, Filing Jointly
37%	> $622,050
35%	$414,701 — $622,050
32%	$326,601 — $414,700
24%	$171,051 — $326,600
22%	$80,251 — $171,050
12%	$19,751 — $80,250
10%	Up to $19,750

#4. Provide tax-free income for trust beneficiaries. The 2019 SECURE Act requires that after you are gone, assets in your retirement accounts must be withdrawn within 10 years by your heirs. If you intend to use a family trust to distribute assets, a Roth IRA makes more sense than a regular IRA. Although annual withdrawals must be compressed into 10 years, at least the amounts withdrawn from a Roth are tax-free, preserving the greatest amount for the future care of your family.

Logistics

- **Converting multiple IRAs.** If you have a bunch of IRAs, some of which were funded with after-tax dollars (non-deductible), you are not allowed to cherry pick which portion gets converted in order to save on income taxes. Here's the rule: The ratio of after-tax to pre-tax across ALL your IRAs before the conversion is reflected in the amount you convert.

  Here's an example: Jill has several IRAs that total $1 million, and her total after-tax contributions to these add up to $200,000, leaving $800,000 (80%) that would be fully taxable. Let's say she converts a third of the total amount, or $300,000, to a Roth IRA. Jill would then owe income taxes on $240,000 of that (80% of the amount converted).

- **Converting other types of retirement accounts**. You can also convert your 401(k) or other retirement plan to a Roth IRA if you no longer work at the sponsoring company. Chances are you would want to move your retirement plan to some type of IRA eventually to avoid the higher fees that are often levied on the accounts of former employees. If you are self-employed and have sizable SEP IRA, you can convert part or all of it to a Roth IRA. But if you are still working, you must maintain a SEP IRA to accept your annual contributions, which for 2020 can be up to 25% of gross annual salary or $57,000, whichever is less.

The Ins and Outs of Roth IRAs

If you are a higher-income household, the path to a Roth IRA is usually to convert an existing IRA to a Roth.That's because there are strict income requirements on opening and funding a Roth IRA. To ***contribute*** to a Roth IRA, you must have:

1. Earned income from work or a job (not from capital gains or investmen income);
2. Household taxable income under $206,000 a year (in 2020) if married filing jointly; $139,000 for singles;
3. Roth contributions at or below the max of $6,000 per person per year ($7,000 if you are 50 and over).

The three rules above do not apply when ***converting*** a regular IRA -- including a SEP IRA for those who are self-employed -- into a Roth IRA. Therefore, conversion is the fastest way to put a lot of assets into a Roth IRA quickly, assuming you can pay the taxes due.

Our Advice: If you do qualify to contribute directly to a Roth IRA, seriously consider it. Even if you are contributing the maximum to your 401(k) plan at work, you can still open a Roth IRA and fund that annually.

Back-door Roth IRAs: As long as you have earned income from a job, you can also fund a regular IRA with *after-tax* contributions (not deductible), up to the annual limit ($6,000 per person; $7,000 for ages 50 and over). Then, after a while, you can convert that IRA to a Roth IRA. If all your IRA contributions have been with after-tax dollars, only the gain is taxable when you convert, and this could make the taxes quite manageable.

Note: In years you make make IRA contributions that are not tax deductible, you must file IRS Form 8606.

- **How the conversion happens.** Most of the time, you would ask the custodian of your IRA, SEP IRA or 401(k) to transfer the funds iinto a Roth account. If you take possession of the amount transferred, you have just 60 days to open up a Roth IRA and deposit the money; otherwise, it will be treated as a withdrawal. Also, your CPA will need to file IRS Form 8606 in the year of the conversion.

Bottom Line

Converting an IRA (or other retirement account) into a Roth is an opportunity that requires careful planning. For one, you cannot undo the transaction later and go back to the IRA.

How can you know if a Roth IRA conversion makes sense for you now and way into the future? We are happy to analyze your situation and run the numbers so you can make the best possible decision.

Don't Overlook a Roth 401(k)

If the company you work for offers employees Roth 401(k)s – and many do these days — you are in luck. To that Roth 401(k), you can contribute as much as $19,500 in 2020 ($26,000 if you are 50 or over), subject only to the plan's contribution rules. What's more, you can contribute the maximum amount to a Roth 401(k), regardless of your household income. You will not get a tax-break for those contributions, but after five years you will be in the clear in terms of taxes.

A drawback: Unlike Roth IRAs, Roth 401(k)s will require you to take annual distributions starting at age 72, but those payouts will be tax-free.

About the Author

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