Thursday TIP

ROTH Conversions

Your clients are probably feeling a little overwhelmed by all the headlines of doom and gloom by now. They would probably find it refreshing to hear about the opportunities that exist, at least in part, because of the pandemic.

When the CARES Act passed March 27, 2020 one of the provisions was the removal of the RMD requirement for this year. This provides an opportunity to review your IRA client's financial outlook and determine whether there are any benefits for them to capitalize on.

- In the past, clients taking an RMD who wanted to do a ROTH conversion of their IRA had to take the RMD first and then do the ROTH conversion based on the remainder of the IRA. Since there is no RMD requirement this year the conversion process is simplified for this demographic.
- The passage of the Secure Act in December changed distribution rules on inherited IRAs. For a non-spouse beneficiary with more than a 10 year age difference than the deceased account owner, total distribution of the inherited account must occur within 10 years. This is similar to the old 5 year rule in that there is no annual RMD, but account must be fully distributed by the 10th year. Brian Brashaw with Ladenburg shared that they came across a scenario recently where a spouse was named as one of several primary beneficiaries. "When the account owner dies, the entire account is treated as Non-spouse, despite the spouse being a beneficiary". So if a client wants to leave 25% each to a wife and 3 kids, the wife loses the stretch advantage. In this situation, it would have made sense for the decedent to have had two separate IRAs with one allocated to wife and one allocated to children. For a large account, the elimination of the stretch in so many instances could mean a significant tax burden on a beneficiary. Does it make sense for current IRA owners to do a ROTH conversion and pay the taxes at their current rate so that their beneficiaries do not face a tax burden when they inherit any remaining assets in the account?
- If a client took an RMD early in the year and is outside the 60 day window to roll it back into the IRA, or completed another rollover within a 12 month period, doing an indirect Roth conversion may make sense. They still pay the tax on the distribution from the IRA but can put the balance back to work in the market and not pay taxes when they ultimately take it out of the Roth.

As of 2020, there are no income limits for a Roth IRA conversion. Income tax on the conversion must be paid in the tax year that the conversion occurred. When weighing the pros and cons of a ROTH conversion it is important to remember, the Tax Cuts and Jobs Act of 2017 (TCJA) banned the recharacterization of a Roth IRA conversion. This maneuver was typically used by individuals who did a Roth conversion and then discovered they couldn't afford the taxes on the conversion so they recharacterized to send it back to the IRA by the following October 15. With the amendment to this rule in 2017 it is vitally important that an individual understand the cost of a Roth conversion before initiating the action.

As you know, distributions from a ROTH are federally tax free and often state tax free provided two parameters have been met. The account has been open for 5 years and the owner is 59 1/2. The grey area to be aware of…the five year rule starts with the first day of the tax year you are making your contribution for. So, if by July 15th, the amended 2020 tax filing deadline and subsequently amended prior year contribution deadline, you were to make a 2019 contribution to a Roth you would technically already meet the first 1 ½ years of the 5 year rule. On January 1, 2024, assuming your client will also have reached the age of 59 ½, they could begin taking tax free withdrawals from the account. But it is important for the client to keep track of date and value of contributions/conversions to simplify the distributions, especially when it comes to earning and net income attributable calculations.

There is no one size fits all solution for investing, but Roth conversions will make sense for some right now if they have experienced a drop in market value. They can pay taxes on the lower amount now, and take advantage of the tax-free growth in the future. For clients who will need to take a distribution next year, a partial conversion may still make sense.