TAX SMART SOLUTIONS BRIEF

Roth Conversions: A Perfect Storm of Opportunity?

At **Tax Smart Network** we believe it takes three things to have a retirement plan you not only understand, but have 100% confidence in: Education, Insight and Action. And we're 100% committed to empowering you with all three in everything we do. In this Solutions Brief we unpack Roth conversions. A timely tax and income strategy worth paying attention to in this current market.

You have many tax-deferred options to take advantage of while saving for retirement. But when it comes time to withdraw, the tax-free options are very few. One option is to open a Roth IRA, but they have low contribution limits. Another potentially more efficient and effective strategy, is a Roth "conversion."

Many retirement experts believe the Roth conversion to be an effective, all-weather strategy and an insurance policy against future tax rates. Today's volatile market and recent legislation make a Conversion even more attractive. Many asset classes have been hammered in 2020. However, with a Roth Conversion, you'll pay less in taxes by making a move today than you would have a few months ago.

Determining when, or if you should convert your investments to a Roth IRA, is an individual decision based on factors such as your financial situation, age, tax bracket, current investments, and alternate sources of retirement income.

EDUCATION

A Roth Conversion is an individual retirement account from which you can withdraw your earnings completely tax-free any time after you reach age 59½, provided your account has been open at least five years. Unlike a Roth IRA, there are no income limits and you can convert more than the $6,000-$7,000 limit.

To complete a Roth conversion you move money from a tax-deferred account you own such as a traditional IRA, old 401(k) plan, SEP IRA, old 403(b) plan and/or old 457 plan into a Roth.

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Here's a summary of Roth conversion benefits:

- **Tax-free withdrawals.** You'll be paying tax on the amount you convert so you can withdraw your original contributions tax-fee (as long as you meet the two qualifying events: your are at least 59 ½ and you've had the Roth for five years).
- **Reduced tax burden for heirs.** The SECURE Act eliminated what was known as the stretch IRA, which allowed heirs to make withdrawals throughout their lifetime, spreading out the tax burden. Under the new law, non-spousal heirs must draw down the entire account within 10 years, significantly increasing the taxes they'll have to pay. By doing a Roth conversion, and paying taxes now, you could significantly reduce the tax burden on your heirs.
- **No minimum RMDs required.** Unlike other types of retirement accounts that require one to take required minimum distributions (RMDs) beginning at age 72, you'll never have to take an RMD from a Roth. This allows your money to grow tax-free for as long as you choose.
- **Tax diversification.** A traditional rationale for contributing to tax-deferred accounts, like 401(k)s and traditional IRAs, is that in retirement you'll earn less and therefore be in a lower tax bracket. However, if your retirement is not in the immediate future, you can't know where taxes will be when that day comes. In addition, current tax rates are still historically low so even with a reduced income in retirement, you could end up paying more taxes in retirement. Diversification in your retirement accounts is a good thing.
- **No time restrictions on contributions.** As long as you have earned income in retirement, you can continue to contribute to a Roth for as long as you wish.
- **Phased conversion.** You are allowed to do phased conversions vs. converting an entire account to a Roth at once, and it may be even better for you. By taking a phased approach, you may stay within your current tax bracket and not be pushed into a higher one.
- **Social Security impact.** Withdrawals do not count towards Social Security provisional income calculations, which can save thousands in Social Security taxation (note: Social Security income is not taxed unless your provisional income is above $34K for singles and $44k for married couples filing jointly). Also, new retirees may have a window of low taxes before they claim Social Security benefits.
- **Medicare premiums.** If you are what Social Security considers a "higher-income beneficiary," you pay more for Medicare Part B, the health-insurance portion of Medicare. Medicare premiums are based on your modified adjusted gross income, or MAGI. That's your total adjusted gross income plus tax-exempt interest, as gleaned from the most recent tax data Social Security has from the IRS. Another benefit of a Roth is that withdrawals on earnings don't count as income, but only if you make what the IRS deems as qualified distributions, thereby potentially lowering your Medicare payment.
- Business owners and investors with pass-through losses can also use unusual tax years to their advantage.

Here's some things to consider before choosing a Roth conversion:

- **Your tax bill.** You can only contribute after-tax dollars to a Roth account, therefore you have to pay taxes on the amount you convert at your current tax rate. Depending on the amount in the retirement savings account you wish to convert, you may have a large tax bill. Also noteworthy is that if you plan to convert an account with contributions that were non-deductible, you only need to pay taxes on the contributions you deducted. These details get a bit dicey to understand so it's always best to speak to a retirement tax specialist.
- **Risk of higher taxes.** When you complete a Roth conversion, you pay taxes at today's current rate for your bracket. Depending on what you'll have for income in retirement and where tax rates are, you could pay more in taxes now than you would have if you left the money in a traditional tax-deferred account. And, depending on how much of your accounts you convert, you might end up in a higher tax bracket for the year you complete the conversion, increasing your tax bill even further.
- **Paying your taxes.** You must come up with the money to pay your taxes on the conversion now. Using money from the account you're converting could be something you consider, but this might

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not be the best idea. Every dollar you use from your retirement account to pay taxes now reduces your earning potential for retirement.

- **Five year waiting period.** You will have to wait at least five years after you do the conversion to withdraw your earnings, without paying a penalty or taxes....even if you're 59 ½. If you're close to retirement and think you may need the funds prior to five years, a conversion may not be the most prudent choice. Please note: you are allowed to withdraw your original contribution amount at any time.
- **No turning back.** After you complete a Roth conversion, you can't put your money back into a tax-deferred account. The government only gives you one chance to make the right choice for you.

Here a brief example of a Roth conversion scenario:

- Age 60 on January 1, 2020
- Establish first Roth IRA on December 31, 2020, by converting a traditional IRA to a Roth IRA
- Must have a qualifying event and satisfy five-year holding period
- Here qualifying event has occurred — you've attained age 59½
- Five-year holding period begins January 1, 2020
- Five-year holding period ends December 31, 2024. Tax-free qualified withdrawals from this Roth IRA, and any other Roth IRA you own, are available anytime after December 31, 2024.

Based on the above pros and cons of a Roth conversion, it's extremely important to speak with a qualified retirement/tax specialist on whether it's a strategy that can benefit you.

INSIGHT

Now that you understand a bit about Roth Conversions and the upside and potential downsides, let's dig into some insight about the current state and future of taxes, along with the current markets. This, along with advice from a retirement/tax specialist, should help you make a more informed decision about whether a conversion is right for you or not.

Let's take a look at a few tax facts that may help guide your decision.

YEAR	TAX BRACKET	HIGHEST RATE
1977	25	70%
1979	16	70%
1982	13	50%
1984	15	39%
1987	5	38.5%
1988-1990	2	28%
1991	3	31%
1993	5	39.6%
2018	7	39.6%
2019	6	37%
2020	7	37%

In the chart above you can see the tax brackets and highest rates since 1977. In 1977 you could move in between 25 different tax brackets and the highest rate was 70%. Fast forward to 1987 and there were 5... you couldn't move in between brackets as easily. Fast forward to 2020 and there are 7 brackets and the tax rate is 37%...third lowest since 1977.

In 2008, we had a stimulus package pass in the amount of $124 billion and then another one in 2009 for $787 billion. In March 2020, we had a $2 trillion stimulus package enacted. In April, another $484 billion was added for small businesses and hospitals. It's likely there will be at least another one in 2020, for as much as $3 trillion based on the shut-down of the economy and unemployment.

How do you think this stimulus money is going to be paid back?

The benefit of converting to a Roth when markets are down is that investors can move a share of their portfolio to a Roth for the same price. When the markets recover, those converted shares will recover in a tax-free vehicle. Not a bad strategy for some.

Here's 4 questions to ask yourself as you consider a Roth conversion:

1. When do you think you'll be able to retire?
2. What does the current situation look like? (i.e. stimulus packages and debt)
3. Will you retire completely? Will you continue to work in retirement? Or will you retire, but work part time?

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4. When you retire, where do you think tax brackets and rates will be and what bracket will you be in?

Future tax rates are not certain. Current rates are pretty low compared to previous years. If you believe they will be higher, and you fit within the guidelines, this could be the "perfect storm" for a Roth Conversion. A well thought-out conversion now, along with a tax-efficient strategy for the future, can allow you to take full advantage of this well-timed opportunity.

Converting before year-end could result in a higher tax bill this year, but you could essentially avoid paying a higher tax rate at the time of withdrawal. The question is whether you believe tax rates will increase in the future when you're ready to withdraw your funds.

There are many things to love about a Roth conversion, along with a few things to watch out for. Low tax cost on conversion now, essentially provides insurance against tax increases in the future, and you have the opportunity to create a tax-free savings account for retirement, even if there are no tax deductions available immediately.

Being prudent with a Roth conversion now will not only help weather the storm of future tax increases that may result from the current massive federal deficit and the recent Cares Act package, but can also extend portfolio life.

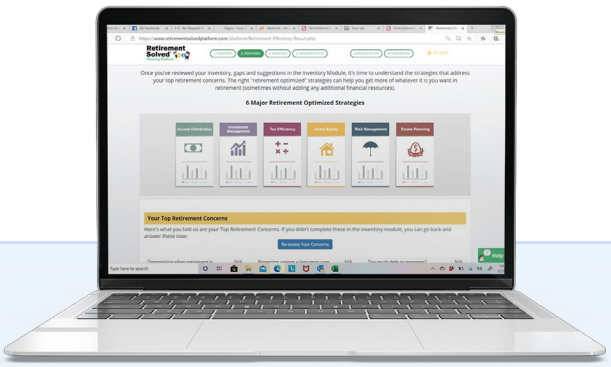
ACTION

Many people choose to sit on the sidelines during crisis, but that's not always the best strategy. To learn if this option is right for you, we encourage you to take action. We can offer you two action steps to take next:

1. Request a 30-minute chat with a Roth conversion/ tax specialist
2. Request a "no strings attached" Roth conversion assessment

www.taxsmartnetwork.com/contact/

Remember: not everyone benefits from a conversion. Our affiliated specialists can give you the education, insight and data to support your decision. A Roth conversion may or may not be part of your overall tax efficiency strategy for lowering your taxes in retirement as much as possible. Conversions are just one arrow in your tax efficiency quiver.



Retirement Optimized Strategies to Help You Have More

Roth Conversions are one part of a Tax Efficient Strategy in retirement. A Tax Strategy is just one of six foundational, multi-disciplined retirement strategies you should have in your retirement plan.

Every pre-retiree should at least understand and consider these strategies as methods to potentially improving a retirement outcome.

1. Income Distribution
2. Investment Management
3. Tax Efficiency
4. Home Equity
5. Risk Management
6. Estate Planning

To learn more about retirement planning and these strategies, and how to create a retirement plan you only understand, but have 100% confidence in, register for free access to our Retirement Solved Planning Platform.

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