ROTH CONVERSION STRATEGIES

The SECURE Act changed the distribution timeline for some beneficiaries of IRA assets. Non-spouse beneficiaries who inherit IRAs (both Traditional and Roth) must now completely liquidate the entire account within 10 years of the original owner's death. This change is effective for all IRAs inherited on or after January 1, 2020.

With recent market events causing a current decrease in some account values, it may be an opportune time to consider implementing a Roth conversion strategy on your Traditional IRA. While the conversion of a Traditional IRA to a Roth IRA will trigger a taxable event (typically the entire conversion amount will be taxed as ordinary income), it may lead to a lower taxable estate and ultimately leave your heirs with a higher net inheritance.

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When your heirs inherit a retirement account, they will now be required to withdraw the entire balance within 10 years. If your heirs inherit Traditional IRA assets, distributions will be taxed as ordinary income, while distributions from inherited Roth IRA assets will be tax-free. By leaving them a Roth IRA, your heirs have the opportunity to hold onto the assets for an additional 10 years of tax-free growth.

The Roth strategy starts with the conversion of your Traditional IRA. Because this event will be taxed as ordinary income, it is beneficial to convert during a market downturn while values are low or spread the conversion over multiple years in order to soften the tax burden. It is preferable to pay the associated taxes from sources other than your Traditional IRA as this will allow you to preserve a larger balance in the Roth IRA to grow tax-free. Additionally, you are not required to take any required minimum distributions (RMDs) from a Roth IRA, which could reduce your taxable income in years following the conversion. Let's walk through some numbers to help illustrate how the Roth IRA conversion strategy could work for you.

Let's assume you start with a Traditional IRA of $1,000,000. While living, you withdraw $500,000 (to satisfy your RMD requirements) and the IRA grows to $2,000,000. Your heirs inherit the $2,000,000 of IRA assets and will be required to withdraw this within 10 years.

Now, with the same facts as above, let's assume you utilize a Roth IRA conversion strategy. When converting a Traditional IRA, you pay taxes now on the amount converted (be aware that the amount you convert could push you into a higher tax bracket). Assuming a 40% blended tax rate, you would owe $400,000 in ordinary income tax on a $1,000,000 conversion. These taxes are paid from other assets and not from the IRA balance. The converted assets then grow to $2,500,000 (remember, no RMDs with a Roth IRA) and your heirs inherit $2,500,000 of tax-free assets.

Another factor to consider when converting a Traditional IRA to a Roth IRA is future tax rates. If income tax rates increase in future years, your RMDs with a Traditional IRA will be subject to higher taxes, reducing the amount of net income available to you. Further, it is possible that your heirs will be subject to higher taxes when they are required to distribute any Traditional IRA assets within 10 years of inheritance.

Converting During a Market Downturn

If you are able to take advantage of a significant market downturn where the value of your $1,000,000 Traditional IRA is hypothetically reduced to $700,000, your tax liability is significantly less and your long-term growth potential in the Roth is significantly more.

While you ultimately pay more in income taxes during your lifetime, the savings to your heirs can be substantial. Let's now assume that your heirs take no distributions until 10 years after inheritance, when the Traditional IRA assets have grown to $4,000,000 and the Roth IRA assets have grown to $4,500,000. At a 40% blended tax rate, your heirs would owe $1,600,000 in taxes with the Traditional IRA versus $0 with the Roth IRA.

Making the decision to execute a Roth IRA conversion is a significant and financially impactful strategy that should be carefully considered by you and your financial planning team. This risk, however, is not without potential reward, as it could reduce future tax obligations and preserve assets for you and your beneficiaries to enjoy.

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