PALLAS CAPITAL ADVISORS

Turning Lemons into Lemonade - the Roth IRA Conversion

June 2022

Summary

- Roth IRA conversions are tax-timing strategies, and now is an opportune time to consider them.
- Given enough time and portfolio growth, the Roth IRA presents the opportunity to increase the after-tax value of the IRA to beneficiaries.
- There are several important factors that should be considered when deciding to pay taxes sooner rather than later. While lower account values may create the opportunity to convert at a lower tax rate, individuals should understand this is typically a long-range planning decision that should be done holistically alongside other basic personal-finance concerns.

Introduction

As I write this (June 10, 2022), the S&P 500 index is down nearly 18% from the beginning of the year, and the Nasdaq index is down over 27% over the same period. So, investors (and their advisors) must increasingly look at additional ways to bring real after-tax value to portfolios. After all, these portfolios are, for many retirees, their primary source of retirement income, and will be for many years. Harvesting tax losses and Roth IRA conversions are two tax planning strategies that should be considered.

Right now (and not just at the end of the year), advisors should be actively engaged in tax-loss harvesting for their clients. "Tax losses are a potential asset that can lessen the sting of market downturns," says Joel Dickson, a tax specialist who is global head of advice methodology for Vanguard Group. Tax losses are valuable since they can be used by investors to offset taxable gains in the portfolio – potentially reducing or even eliminating the tax from those gains.

Another tax planning strategy that should be considered is the Roth IRA conversion. We have touched on this in past newsletters, but due to the prolonged market correction/bear market, it's worth revisiting in some more depth. Quite simply, a market pullback of 20%–30% essentially means that taxes have been cut by 25% when performing a Roth conversion. This market is providing a perfect opportunity to consider a Roth IRA conversion.

IRA vs. Roth IRA

With a traditional Individual Retirement Account (IRA), an account owner contributes pre-tax dollars, and withdrawals during retirement are then taxable.

Conversely, contributions to a Roth IRA are made with after-tax dollars, and withdrawals during retirement are tax-free when they are distributed according to IRS rules. (A distribution from a Roth IRA is tax-free and penalty free, provided the 5-year aging requirement has been satisfied and one of the following conditions is met: age 59-1/2, disability, qualified first-time home purchase, or death.)

In 2022, full Roth IRA contributions are allowed if the taxpayer's Modified Adjusted Gross Income (MAGI) is not greater than $204,000 (married, filing joint – reduced to $129,000 for single filers). Contribution limits begin to be reduced when MAGI is between $204,000 and $214,000 ($129,000 and $144,000 for single filers) and fully phased out when MAGI is greater than $214,000 ($144,000 for single filers). The contribution limit for Roth IRAs is $6,000 in 2022. ($7,000 for age 50+).

There are no income limits for Roth IRA conversions.

Roth IRA Conversions

A Roth IRA conversion enables an individual to take all or part of an existing traditional IRA and convert it to a Roth IRA. Converting assets held in an IRA to a Roth IRA so that they are distributed tax-free might sound like a good idea, but this comes with a cost – namely paying taxes today in exchange for a potentially lower future tax liability. When converting IRA assets into Roth IRA assets, the owner must pay taxes on the original deducted contributions as well as money earned on the investments in the IRA.

In its simplest form, when determining if a Roth conversion makes sense for you, it comes down to your current tax bracket and whether you think your bracket will be higher or lower in the future. Therefore, if you think your tax rate will be higher in the future, you should at least consider performing a Roth conversion today as a tax arbitrage strategy.

Roth conversions can make sense for many individuals, as it is likely that tax rates will only go up, particularly considering that many of the more favorable income tax provisions of the 2017 Tax Cuts and Jobs Act are sunsetting in 2025.

Roth Conversion Considerations

1. **Do it Over Time**
   While an investor may be able to pay the taxes on the entire conversion amount, it may be advisable to engineer partial conversions over several years. In this fashion, the income generated by the conversion ideally is taxed at a lower rate. Consider converting no more than what will allow you to remain in your present federal tax bracket.

2. **RMDs are Not Eligible for Conversion**
   Required Minimum Distribution (RMD) amounts are not eligible to convert to a Roth IRA. RMDs must be taken in the year of conversion before converting to a Roth IRA.

3. **Find Ways to Offset the Income**
   When planning a Roth IRA conversion, individuals should consider reducing adjusted gross income (AGI) by contributing more to a pretax 401(k) plan, if available to them. One may also employ tax-loss harvesting in a taxable account.

4. **Don't Get Surprised**
   Because a Roth conversion usually means that one's adjusted gross income will be increased by the amount of the conversion – one needs to think about what additional income levels mean in addition to simply additional amounts subject to income taxation. Retirees may unknowingly trigger higher Medicare premiums after converting. For those residing in states that impose an income tax, a Roth IRA conversion will likely be treated as taxable income by one's home state. Other potential downsides are the possibility of losing eligibility for such write-offs as the child tax credit or the student loan interest deduction. These are the types of issues of which individuals need to be aware so an informed choice can be made.

5. **Good Things Don't (Usually) Last Forever**
   Often, investors will convert their IRA accounts to Roth IRAs for purposes of helping their heirs receive future tax-free distributions. During the Roth IRA owner's lifetime (and his/her spouse, if named as beneficiary), there is no RMD on amounts held in a Roth IRA. However, it is important to note if the account holder died after 2019 (the SECURE Act), non-spouse designated beneficiaries planning to spread distributions over their life expectancy will instead have to fully withdraw the funds within 10 years.

But Wait - Roth Conversion *Reconsiderations*

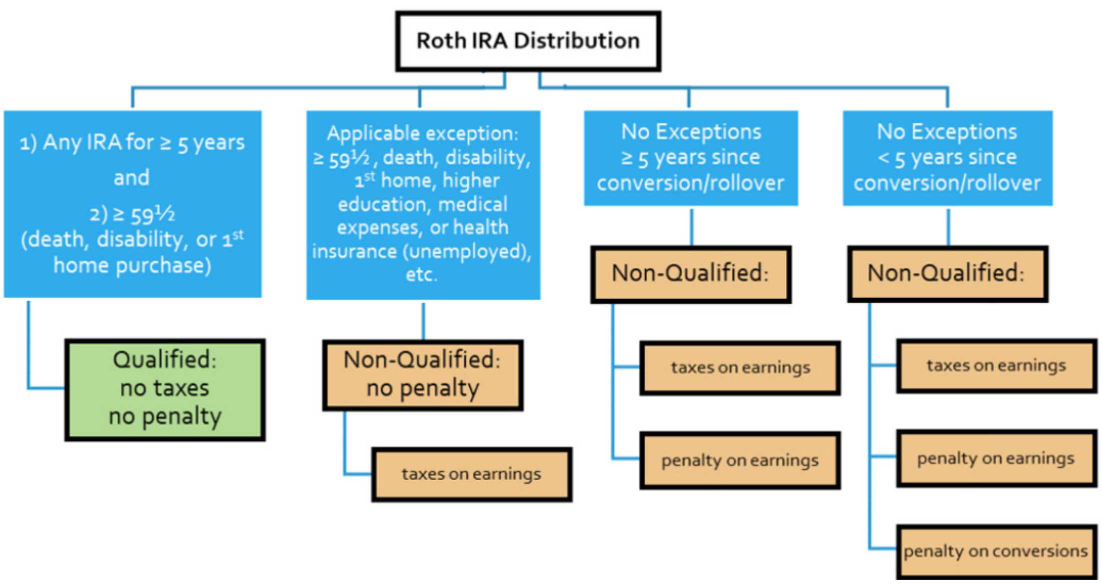
Just like most tax planning strategies, a Roth conversion is not right for everyone's situation. Consider these potential disadvantages before you make the move:

1. **Your tax bracket may be lower in future years**
   There's a good chance that in the retirement stage in life one's overall income may be lower. (Of course, marginal tax brackets may also be higher!)

2. **You can't afford to pay the tax due from the conversion**
Individuals should plan to pay for IRA conversion costs with their non-retirement savings. If you pay the taxes using funds from the IRA, your new Roth IRA will have much less money in it, making it more challenging for the reduced funds to grow enough to overcome the cost of conversion. Moreover, since money withheld from the conversion for taxes counts as an IRA distribution, if you are under age 59 ½, you will owe a 10% penalty on the withdrawal in addition to the income taxes.

3. **You might need the money within 5 years**
Typically, the longer funds remain in a Roth IRA, the greater the potential for tax-free investment growth. However, a Roth IRA conversion may not be suitable for the individual who anticipates taking withdrawals within five years of converting. Here are very important questions to ask when distributing from a Roth IRA:
   - How long ago did you complete the Roth Conversion?
   - How old are you?
   - Does a distribution "exception" apply? (See chart below)

   Roth IRAs and Roth conversions involve a couple of "five-year rules" that can generate taxes or penalties. *It's important to note that each Roth conversion has its own five-year clock.*
   - You can withdraw *contributions* from a new Roth IRA at any time tax and penalty-free. (Important - converted funds are not considered "contributions" for purposes of avoiding income tax.)
   - If you are over 59 ½ *and* you have met the five-year holding requirement, you can also withdraw earnings from a Roth IRA with no taxes or penalties. Even if you have multiple Roth IRAs opened in different years, the five-year clock starts on January 1 of the first Roth IRA.
   - If you are 59 ½ and older but don't meet the five-year holding period, you are subject to taxes but not penalties. Recall that every Roth conversion has its own five-year clock—in contrast to a Roth IRA where the five-year rule is satisfied by any Roth IRA that has been opened.
   - If you are not over age 59 ½ and do not satisfy an exception, then a 10% early withdrawal penalty and taxes will apply to the amount distributed.



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4. **You could plan to leave your IRA to a charity**
Nonprofit organizations are usually exempt from paying any taxes on the distribution of funds from any IRA. From an economic standpoint, you would not want to convert a traditional IRA, pay taxes, and then leave the Roth IRA to a charity. Since traditional IRA funds are pretax, they are the best assets to give to charity.

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5. **Your beneficiay may also have a lower tax bracket**
When it comes down to deciding whether to convert (or not), it may come down to whether the account owner and perhaps, more importantly, his/her beneficiary, is likely to be in a lower marginal tax bracket.

6. **You could have large, deductible medical expenses in the future**
If all traditional IRA monies were converted to Roth IRAs, there would be no traditional IRA distributions left to absorb future medical deductions (or other itemized deductions), and the deductions would be lost. This includes nursing home costs and other big-ticket expenses related to medical conditions. Currently, medical and dental expenses are deductible to the extent that, in the aggregate, they exceed a "floor" of 7.5% of adjusted gross income.

It would not make sense to pay tax on converted funds if those funds were not otherwise going to be taxed due to deductible medical expenses in future years.

7. **If you own a business**
If you own a business now—or in the future—future losses could be used against IRA distributions, reducing (or even eliminating) the tax impact on those withdrawals.

Conclusion

Taxes are always a concern, and now more than ever with revenue generation ideas floating around. A Roth IRA conversion merits serious consideration, particularly with the pullback in the stock market thus far in 2022. Of course, as with all tax planning strategies, such decisions should be made in coordination with other major financial planning decisions for maximum effectiveness. The individual's age, investment time horizon, the value of assets being converted, and current and future tax brackets are among the factors one needs to consider.

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