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ROTH CONVERSIONS — IMPORTANT PLANNING CONSIDERATIONS

A Roth conversion is one planning opportunity to consider. Identifying clients, understanding the income and estate tax ramifications, modeling the client's cash needs, adjusting the asset allocation of the plan assets and implementing the conversions are important steps and considerations to understand.

Target Audience

Clients with current-year ordinary losses, clients with the ability to use NOLs, clients having charitable deduction carryforwards, clients with high-basis IRAs and clients with other tax-favorable attributes may present situations where converting makes sense. Clients falling into a lower tax bracket this year compared to previous years, or clients projected to be in lower brackets this year vs. future years, may consider a conversion. There are no income limitations on Roth conversions, and they are available regardless of an individual's eligibility for Roth or deductible IRA contributions. Clients, especially those with a projected taxable estate and with an intention to pass their IRA assets to their children or other noncharitable beneficiaries, may be good candidates for a Roth conversion. Clients who are active participants in a company retirement plan will need to consult with their plan sponsor to see if their plans allow for Roth conversions, and how a conversion to a Roth IRA would impact their contribution testing. Clients considering a Roth conversion ideally have liquid, tax-neutral assets available outside the qualified account to pay the resulting conversion tax.

Income and Estate Tax Considerations

One of the key evaluation points in deciding to convert or not, including how much to convert, relates to income tax bracket management. It is critical to project what net-after-tax assets are available in both the required minimum distribution scenario vs. Roth conversion scenario. How much does the conversion push the client up in higher tax brackets? What brackets could the client be facing in future years upon the sunset of current regulations, or in even higher tax years of future administrations? In preparing these calculations, it is important to understand the basis of the qualified assets and what other changing income or deduction items could impact the results. Partner with the client's tax advisor to be sure to have the necessary assumptions factored into the mathematics of the analysis.

Planning for qualified retirement accounts is also important due to the Setting Every Community Up for Retirement Act of 2019 (The SECURE Act) and the subsequent SECURE Act 2.0 of 2022. These laws impact retirement plans in many ways, including the elimination of the "stretch" IRA for many beneficiaries that would inherit these accounts. Individuals who planned to leave qualified retirement plan assets to a noncharitable beneficiary, other than a spouse, may need to take another look at what will happen once they pass away under the new law, and update their estate plan accordingly (especially individuals leaving these accounts to a trust). Prior to the SECURE Act, an individual inheriting an IRA could "stretch" distributions from the account over his or her life using factors that were provided by IRS tables. This meant that if a child or grandchild inherited the account, the required distributions could be spread out over many years, reducing taxes and increasing compounding returns.

The SECURE Act rules state that as of January 1, 2020, these account balances must be liquidated in full by the 10th year following the year of the decedent owner's death. Post-death distributions to beneficiaries are tax-free when coming from a Roth IRA, but not from a traditional IRA. The prepayment of tax on the conversion combined with a long-term horizon of subsequent, tax-free growth of the plan balances make the Roth IRA attractive in terms of wealth transfer planning.

Cash Needs and Distribution Planning

Tax minimization should not be the only consideration in the Roth conversion decision. Advisors also need to consider and measure the client's cash flow needs and projected distributions from the qualified assets. For example, if the client needs access to the qualified funds within the next five years, converting may not be the answer. If the client has few other liquid assets, takes minimal distributions from his/her businesses or is expected to use the majority of his/her qualified assets to maintain his/her lifestyle due to other circumstances, converting may not be appropriate. Clients who have charitable beneficiaries designated already or clients who are contemplating charitable giving using Qualified Charitable Distributions (QCDs) may not be suitable candidates for a Roth conversion. Plan to review how the client's Medicare premiums could be impacted by the additional conversion income. Evaluating the Roth conversion as part of the client's overall financial plan is a prudent step in this decision-making.

Asset Allocation Decisions

In addition to the tax and cash flow considerations in a Roth conversion, advisors should also evaluate what asset allocation changes should weigh into the planning. Typically, growth-oriented investments should be used instead of income-oriented investments in a Roth IRA to maximize the after-tax growth potential of the account; however, expected volatility of the underlying assets also needs to be evaluated. Advisors should plan for allocating assets with a balance of long-term appreciation potential with as limited projected volatility as possible. Diversification among asset classes within the Roth portfolio will remain important in achieving this.

Rebalancing the client's other accounts may be necessary following a Roth conversion. If growth assets are shifted to the Roth account and assets are withdrawn from taxable accounts
to pay the conversion tax, this is a good time to review overall asset location and asset classes vs. desired targets for the client.

Implementation

After careful consideration and planning, once a client decides to convert some (or all) of their qualified assets to a Roth IRA, the next steps include processing the conversion transaction(s) with the custodian(s), taking care to reallocate the assets, and confirming the appropriate beneficiary designation with the estate attorney. Please be sure to follow up and confirm the amount and timing of the conversion with the tax advisor. The tax advisor will need to include this income in the client's tax projection and confirm the amount of tax reserve needed for estimated payments or any balances due in April.

Pros and Cons of a Roth Conversion

A Roth IRA conversion may present an opportunity for clients to address both income tax and estate tax minimization; however, there are numerous other important factors for the clients to contemplate. Some of those considerations are outlined in this summary, and include:

- **Pros:**
  - Roth Accounts grow on a tax-exempt basis and do not have a required minimum distribution requirement at age 72.
  - There is the opportunity to accelerate income into a lower income tax year.
  - Estate taxes, including inheritance taxes levied at the State level, can be reduced or avoided with Roth conversions.
  - There is the opportunity to optimize wealth transfer to beneficiaries with a long-term horizon.
  - Roth conversions do not represent an all-or-nothing situation; flexibility using partial conversions or staggered conversions are available.
  - Clients with identifiable situations, such as reduced earned or passive income, ordinary losses, NOLs and large charitable carryforwards may benefit from converting.
- **Cons:**
  - If a client has existing charitable intentions for the IRA assets, this planning may not be the most appropriate path to take with an IRA.
  - Recharacterizations of Roth conversions are no longer available; murky client facts need to be resolved before proceeding with this planning.
  - If a client needs access to the IRA assets for cash needs or does not have other access to other liquid, tax-neutral assets (like cash) to pay the conversion tax, converting benefits may be reduced or eliminated.
  - Future legislation may limit the intended benefits or functionality of Roth IRAs.
  - State and local tax rules need to be considered and may impact the effectiveness of this technique.
  - Seek counsel on the consequences of converting qualified plan assets to a Roth, and how that impacts bankruptcy and creditor protection.
  - No guarantees can be made that taxes are going to increase, and a client could ultimately end up paying more tax by converting than not.

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