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Today's Lower Tax Rates Make Roth Conversions Appealing

Tax rates are projected to rise and could remain higher for a longer time period. A low tax rate environment presents unique timing for clients to evaluate whether a Roth IRA conversion may be a beneficial wealth preservation tool. Converting part or all of the balance of a Traditional IRA or Rollover IRA to a Roth IRA at current lower tax rates could potentially shield more wealth and lower future tax obligations.

A low tax rate environment presents unique timing for clients to evaluate whether a Roth IRA conversion may be a beneficial wealth preservation tool.

Conversions allow high net worth individuals who have compensation income above Roth limits to access the tax-free benefits of Roth IRAs. Converting assets from a tax-deferred Traditional IRA or Rollover IRA to a tax-free Roth IRA may not make sense for everyone, but over the next couple of years as higher taxes are phased in, any reduction to your taxable income may be reason to consider converting all or part of your Traditional IRA or Rollover IRA to a Roth IRA. Business losses that can be deducted or other deductions that may lower your taxable income such as medical expenses or large charitable contributions may be circumstances that cause your taxable income to decline. Be alert to situations and opportunities that warrant consideration for a conversion. Let your wealth advisor know of any changes to your taxable income so they can advise you and work with you and your tax professional on the best strategy.

Conversion is permanent, so it is important to discuss and understand the pros and cons with your wealth manager and tax professional before you decide. There are many scenarios where a conversion may be a smart tax strategy, for example if you anticipate a higher taxable income in the future or are a new retiree who now falls in a lower tax bracket; however, there are also instances where a Roth conversion may be less compelling.

The information provided here should not be considered to be tax advice and all investors should consult their tax professional about the specifics of their own tax situation to determine any proper course of action for them. KAR does not provide tax advice and nothing herein should be construed as tax advice, and information presented here may not be true or applicable for all income tax situations. Tax laws can and frequently do change, and KAR does not undertake to update this should any changes occur.

Roth IRA Benefits

Conversions allow high earners access to:

- Tax-free withdrawals
- Assets compound tax-free
- Typically, no forced Required Minimum Distributions (RMDs) that may push you or your heirs into a higher tax bracket[1]
- Tax-free inheritance to your heirs
- May help reduce your total taxable estate value

Considerations and Estate Planning Advantages

Keep in mind that a Roth IRA must be held for five years before taking any distributions after age 59½. If you believe you may need access to your money sooner, a conversion may not be appropriate. Also, when you convert all or part of the Traditional IRA or Rollover IRA to a Roth IRA, the amount converted is reportable income and will increase your adjusted gross income, which is why it is important to consider a conversion when taxable income may fall in lower tax brackets. To avoid paying taxes twice on the converted assets and depleting an important source of future funds, tax professionals often recommend paying the tax from a cash source other than the IRA account. Because assets converted are reportable income and may increase your taxable income and tax bracket, a series of conversions can be completed, while conditions are favorable, to spread the tax load over multiple years.

For estate planning purposes, the value of retirement plan assets is included in gross estate tax calculations and could be subject to estate taxes. If you have sufficient income and assets to cover your cost of living expenses and do not need the full Required Minimum Distribution from a Traditional IRA or Rollover IRA and plan to leave it to your children or other family, a conversion at today's lower tax rates may help reduce the overall value of your estate by the income tax paid. With an inherited retirement plan asset, your heir could potentially be taxed twice with the estate tax you paid and the ordinary income tax they would pay on withdrawals. Often times your heir may be in their prime earning years at the time of an inheritance and taking a distribution may push them into an even higher bracket and limit the value of the inherited assets. By converting to a Roth, your heir could inherit a tax-free account and if so, would not need to worry about the timing of a distribution that could be burdensome to their tax situation. Non-spouse beneficiaries of Traditional and Roth IRAs must take distributions within 10 years from the date of the account owner's death. Converting during a market pullback could also be advantageous with the assumption that security prices will recover and the growth will now be in the tax-free account and the amount of tax paid is on a lower conversion amount.

1 *There are required withdrawals for beneficiary Roth IRAs within 10 years of non-spousal inheritance. Always consult your tax consultant or financial advisor for advice on your specific situation.*

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Today's Lower Tax Rates May Create a Roth Conversion Opportunity

Current Law					Biden Proposal				
Single		Married		Rate	Single		Married		Rate
Over	But Not Over	Over	But Not Over		Over	But Not Over	Over	But Not Over	
$0	$10,068	$0	$20,136	10%	$0	$10,068	$0	$20,136	10%
$10,068	$40,973	$20,136	$81,946	12%	$10,068	$40,973	$20,136	$81,946	12%
$40,973	$87,395	$81,946	$174,790	22%	$40,973	$87,395	$81,946	$174,790	22%
$87,395	$166,824	$174,790	$333,647	24%	$87,395	$166,824	$174,790	$333,647	24%
$166,824	$211,844	$333,647	$426,689	32%	$166,824	$416,700	$333,647	$416,700	33%
$211,844	$529,663	$426,689	$635,585	35%	$416,700	$418,400	$416,700	$470,700	35%
$529,663	and over	$635,585	and over	37%	$418,400	and over	$470,700	and over	39.6%

Data is as of June 2020 and is obtained from the American Enterprise Institute, an Analysis of Joe Biden's Tax Plan. for high earners, the combination of increased future rates to 39.6%, higher potential social security tax (6.2%), Medicare Tax (0.9%) and a potential net investment income tax (3.8%), lifts the top bracket past 50%.

Tax Diversification Strategy

Since no one can truly predict the future of taxes over time, leveraging a tax diversification strategy, which means having investments in taxable, tax-deferred and tax-free accounts, may be beneficial. Having money in each type of account could reduce the chance that your investments will be negatively impacted by tax code changes. As your tax bracket changes, one has better options to manage their overall tax obligations if they are able to diversify their investments in all three types of accounts. For example, in a low tax bracket year, you may want to take money from a Traditional IRA. In a high tax bracket year, taking money from a tax-free account may offset taxable income. Taking long-term gains from a taxable account is another option since the capital gains tax may not be as high as ordinary income tax and may be offset by losses.

Prudent tax planning and timing can help grow wealth and reduce taxes. However, there are many considerations to a conversion so it is important to understand all of the tax implications before you decide. Please connect with your KAR Wealth Advisor should you wish to discuss your situation and we can work with you and your tax professional to complete an analysis to help you make the right decision.

Kayne Anderson Rudnick is an investment firm specializing in high-quality investment and wealth management strategies. The firm has over a 30-year history serving a diverse client base that includes high-net-worth individuals, corporations, endowments, foundations, public entities, taft-hartley clients, and mutual funds. Kayne Anderson Rudnick is known for its commitment to high-quality investment strategies and business practices. For more information, please visit www.kayne.com.