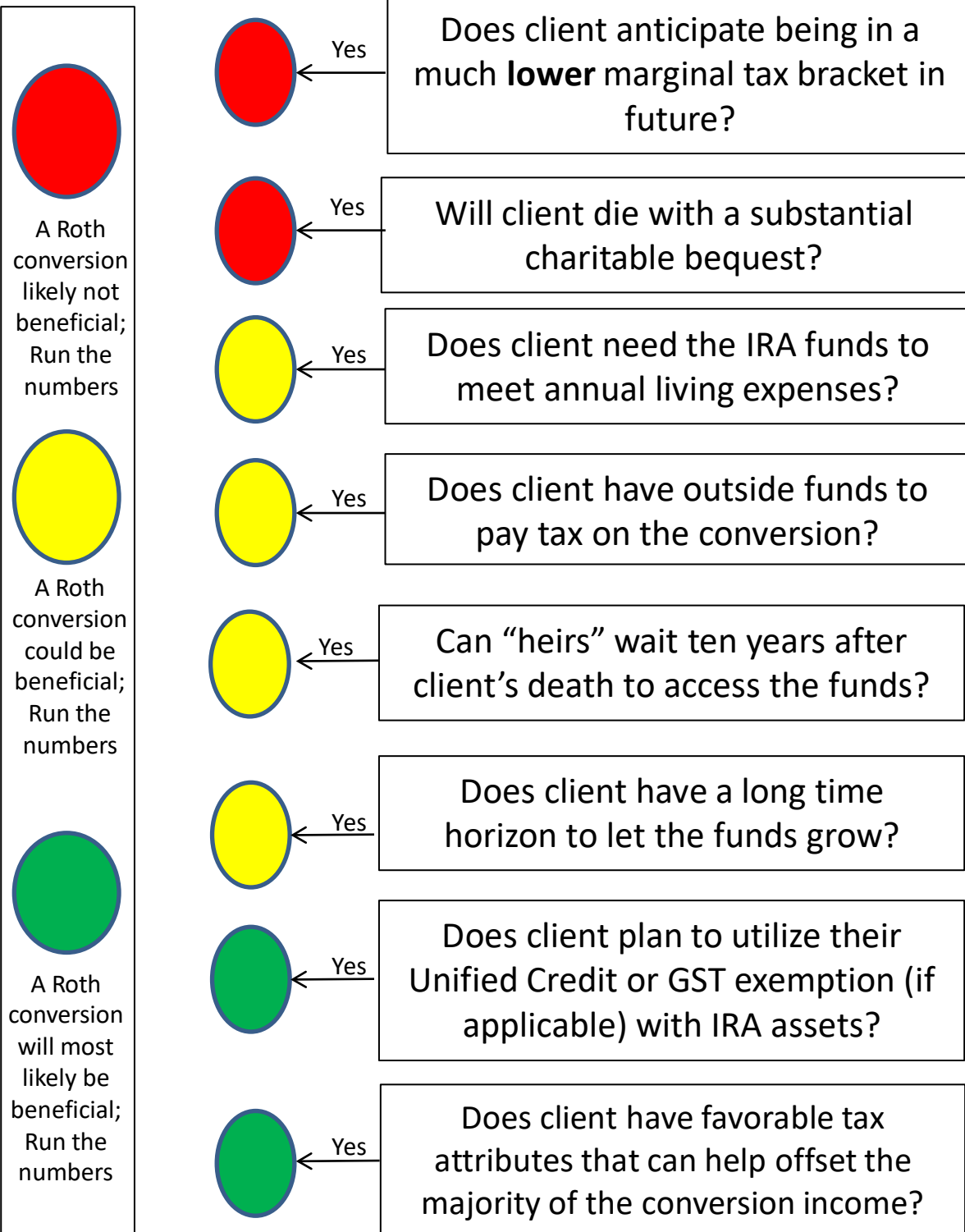


Robert S. Keebler, CPA/PFS, MST, AEP: The Roth IRA Conversion Decision

Should a client convert to a Roth IRA?



Bob Keebler's Roth Conversion Observations

1. After determining the "optimum" conversion amount, additional amounts converted may be detrimental in that they increase the effective tax rate on the conversion.
2. The Roth IRA is the most powerful asset with which to fund a GST exempt trust.
3. There is no bright line rule or "optimum" conversion amount for all individuals, considering that each individual's financial, income tax, and wealth situations are different. If several of the eleven reasons are met, it is likely the individual is a good candidate for a Roth IRA conversion.
4. Partial conversions generally provide a better quantitative result than 100% conversions.
5. Convert while married (before the first death) to take advantage of the married brackets.

10 Reasons to Convert to a Roth IRA

1. Taxpayers have special favorable tax attributes, including a high basis ratio, charitable deduction carry-forwards, investment tax credits, net operating losses (NOLs), etc. *This is because these attributes reduce the effective tax rate of the conversion.*
2. Suspension of the minimum distribution rules at age 72 provides a considerable advantage to the Roth IRA holder. *This allows for additional tax-free deferral.*
3. Taxpayers benefit from paying income tax before estate tax (when a Roth IRA election is made) compared to the income tax deduction obtained when a traditional IRA is subject to estate tax. *This is because the IRC § 691(c) deduction is inefficient.*
4. Taxpayers who can pay the income tax on the IRA from non-IRA funds benefit greatly from the Roth IRA because of the ability to enjoy greater tax-free yields. *This is because of the ability to move funds from a "taxable" to a "tax-free" tax asset class.*
5. Taxpayers who want to leave IRA assets to their family, are well advised to consider making a Roth IRA election for that portion of their overall IRA funds. *This is because no distributions are required for ten years after death, generally.*
6. Post-death distributions to beneficiaries are tax-free. *This is possibly the most advantageous aspect of a Roth IRA conversion.*
7. Because the highest federal tax bracket is more favorable for married couples filing joint returns than for single individuals and because individual brackets are compressed compared to married individuals a Roth Conversion before the first spouse's death may be prudent. *(See chart on page two.)*
8. 199A Qualified Business Income Deduction. *A conversion may be beneficial for business owners because Roth IRA qualified distributions are not considered taxable income for purposes of computing the limits on the deduction.*
9. 3.8% Net Investment Income Tax. *A conversion may be beneficial for taxpayers because Roth IRA qualified distributions are neither net investment income nor MAGI.*
10. Tax rates are historically very low. *Higher tax rates in the future means more tax will be paid on taxable IRA distributions than the tax that would be paid on a conversion at a lower rate*

Important Tax Law Considerations

CPA's Checklist

CPA's Checklist

- Analyze Tax Rates
- Consider Tax Attributes
- Determine Amount to Convert
- Convert by Asset Class
- Determine Tax Estimates
- 3.8% NIIT Planning
- Consider Oil and Gas Investments
- Monitor AMT
- Monitor Taxation of Social Security Benefits and Increases in Medicare Premiums
- Consider the new post-mortem 10-year rule does not require distributions until year 10.

Death & Married Rates

- If death of a married taxpayer is imminent, it may be more advantageous to convert to a Roth IRA while the taxpayer is still alive in order to avoid the compressed brackets for single individuals.
- Post-death distributions are tax-free.

Alternative Minimum Tax

- If the taxpayer is close to being exposed to AMT prior to the implementation of a Roth conversion, the practitioner must be aware of the effects of state and local taxes.
- Although federal income taxes may be offset by an applicable deduction, state and local taxes that typically tag along are not deductible for AMT purposes under §56(b)(1)(A)(ii).

State Taxes

- Roth conversions may be treated differently from state to state.
- Consider local tax implications.

Recent Acts

- Pension Protection Act of 2006:** Non-spousal beneficiaries are permitted to roll over a qualified retirement plan (e.g. 401(k) plan), via trustee-to-trustee transfer, into an inherited IRA effective for tax years beginning after December 31, 2006.
- The Small Business Jobs and Credit Act of 2010:** Allows the conversion of 401(k), 403(b) and governmental 457(b) plans to Roth accounts. Keeping the retirement funds in a Roth 401(k) rather than converting to a Roth IRA can be beneficial from an asset protection standpoint. However, the recharacterization option is not available under this provision as it would be if account were converted to a Roth IRA.
- The American Taxpayer Relief Act of 2012:** A plan can now allow a participant to move a 401(k) to a Roth 401(k) while working. Previously, a triggering event such as severance from service was required.
- The Tax Cuts and Jobs Act of 2017:** Repealed the ability to recharacterize a Roth Conversion.
- The Secure Act of 2019:** Repealed post-mortem distributions based on the beneficiary's lifetime ("stretch IRA") and instead generally requires IRAs to be fully distributed within ten years of death.

Important Financial Considerations

Financial Advisor's Checklist

- Assess overall market conditions/factors to determine if a Roth IRA conversion is prudent
- Determine asset class and/or group of assets to convert
 - Should consider the Roth IRA more of a "long-term investment" or an "inheritance tool."
 - Growth-oriented investments should generally be used instead of income-oriented investments.
 - Need to consider investment volatility.
 - Now that recharacterizations are no longer allowed, care must be taken to choose an asset class/group of assets that has decent long-term appreciation potential but not a lot of volatility (e.g., SPDRs).
- Work with CPA to determine the amount to convert
 - Smaller conversions are usually going to be better than larger conversions due to "tax bracket creep."
 - Need to address how soon the Roth IRA may be needed to cover the client's annual cash flow needs.
 - If the Roth IRA will be needed within the next five to ten years, then a Roth IRA conversion most likely will not make sense.
 - This can be determined by doing a discounted cash flow needs analysis to arrive at "convertible capital" (i.e., traditional IRA balance not needed to meet future annual cash flow needs).
- Determine source(s) for which to pay the income tax on the conversion
 - Cash/cash equivalents should be used to the greatest extent possible (due to low opportunity cost).
 - Non-qualified investments should be considered next.
 - Need to consider impact of additional income tax on asset liquidations to pay the income tax on the conversion.
 - Traditional IRAs should be considered only to the extent cash/cash equivalents and/or non-qualified investments are not available to pay the income tax on the conversion.
 - Need to consider impact of additional income tax of additional IRA withdrawals.
 - Roth IRAs should be considered last.
- Assess the need for life insurance and/or annuities
 - Life insurance should be compared as an alternative to Roth IRA conversions to see which scenario passes more after-tax assets to beneficiaries.
 - Life insurance should be considered as a potential "bail-out" of large traditional IRAs (until the large traditional IRAs can be pared down through periodic Roth IRA conversions).
 - Annuities should be considered as a "cash flow hedge" during the IRA owner's lifetime so that the Roth IRA doesn't need to be tapped into as much.

Important Estate Planning and Asset Protection Considerations

Lawyer's Checklist

Estate Planning Considerations

- Ensure that beneficiary designation forms are updated to seamlessly integrate the Roth IRA into the overall estate plan.
- Consider that post-death qualified distributions are tax free.
- Consider utilizing a Roth IRA to fund unified credit trust and/or a generation skipping transfer tax exempt trust (if applicable).
- Ensure that appropriate tax apportionment clauses are addressed in planning documents. Estate taxes should generally be apportioned away from the Roth IRA asset thereby enabling the Roth IRA to continue to grow on an income tax-free basis.
- Consider utilizing a charitable split interest trust as a tool in minimizing income tax in the year of a Roth IRA conversion.
- Ensure that an individual's durable power of attorney will provide the attorney-in-fact with the right to make any and all tax elections, including an election to recharacterize the Roth IRA.
- Asset Protection Considerations**
 - Consider implications on bankruptcy and creditor protection under federal and applicable state law before converting a qualified plan or traditional IRA to a Roth IRA.
 - Consider utilizing a standalone IRA Trust to be beneficiary of the Roth IRA for asset protection purposes.

Applies to Deaths on or after January 1, 2020

| DISTRIBUTIONS TO BENEFICIARY UNDER IRC § 401(a)(9) ROTH IRAS | | | |
|---|---|---------------------------------|---|
| Beneficiary | | Beneficiary | |
| Spouse - Inherited IRA (No rollover) | Spouse may defer required distributions until the year the owner would have reached age 72. In this year and for each succeeding year, the RMD is calculated based upon spouse's life expectancy by referencing her attained age for the year of distribution based on the Single Life Table. | Designated Beneficiary | The IRA must be fully distributed within ten years of the owner's death. |
| Spouse - Rollover | No RMDs required during spouse's life. | Eligible Designated Beneficiary | RMDs calculated based upon corresponding life expectancy factor for the beneficiary's age in the year of the first distribution by reference to the Single Life Table. For succeeding years, this factor is reduced by one. |