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## MBL Advisors

### **Summer/Fall 2022 Gift Tax Series:** **Volume 3: The Hidden Gift of Roth Conversions**

We are asked frequently by our clients whether they should contribute to a Roth or a traditional IRA (or if they should consider converting traditional IRA assets to a Roth. And while there are myriad variables to consider, one of the more succinct responses we've encountered is the rhetorical question: *would you rather be taxed on the seed or the harvest?*<sup>1</sup>

That overgeneralization would infer that Roth is always the answer, which of course is not accurate. That said, there are compelling factors that make this moment in time an appealing time to consider Roth conversion independent from the general observation that tax on a seed is less than tax on fully grown produce. Market forces and legislative changes are chief among those factors. And while the seed/fruit analogy serves to simply explain the income tax implications of a conversion during the lifetime of the taxpayer, the primary purpose of this article is to highlight the wealth transfer power of a Roth conversion, which is a great estate and gift tax strategy even if it's hiding in plain sight like the Purloined Letter.

**Legislative Context.** There are two recent legislative events that are relevant considerations to the decision, as Hamlet put it, "to Roth or not to Roth." In 2017, the so called Trump Tax Cuts or the Tax Cuts and Jobs Act ("TCJA") changed the transfer tax and income tax landscape significantly. More recently, the SECURE Act had big ramifications for retirement accounts broadly. At a very high level, it's worth understanding those impacts in the context of a contemplated Roth conversion.

**TCJA.** Since Jan 1, 2018 when the TCJA became effective, income taxes have been "on sale." As referenced in our earlier writing on SLATs [here](#), TCJA doubled the estate tax exemption until the earlier of (i) Congress making changes to the TCJA or (ii) the legislation's built-in sunset of Jan 1, 2026. So, you could say that it put dying with significant wealth on sale. Someone with a \$20mm net worth would owe significantly less estate taxes in 2018 than in 2017. To put dollars around that, a single person with a \$20mm estate on Dec 31, 2017 would have owed \$5.8mm in estate taxes, whereas the same person dying on Jan 2, 2018 would have owed \$3.5mm, meaning he got about a 40% discount on dying by waiting 3 days.

Similarly, the TCJA put *income* taxes "on sale" for the tax years 2018-2025 as well, and it did so in two related but different ways. First and most importantly, it reduced the income tax *rates* for several of the marginal tax brackets (i.e., the 15% bracket went to 12%, the 28% bracket became 24%, and so forth). Second, the dollar figures for many of the tiers' breakpoints for the margins changed as well, especially so for higher income tax earners. The

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<sup>1</sup> <https://www.kiplinger.com/retirement/retirement-plans/roth-iras/604539/i-love-roth-iras-and-roth-conversions>

chart below highlights both changes, based on 2018 income tax brackets for married taxpayers filing jointly (“MFJ”).

**Married filing jointly (2018)<sup>[26]</sup>**

Under previous law		Under TCJA	
Rate	Income bracket	Rate	Income bracket
10%	\$0–\$19,050	10%	\$0–\$19,050
15%	\$19,050–\$77,400	12%	\$19,050–\$77,400
25%	\$77,400–\$156,150	22%	\$77,400–\$165,000
28%	\$156,150–\$237,950	24%	\$165,000–\$315,000
33%	\$237,950–\$424,950	32%	\$315,000–\$400,000
35%	\$424,950–\$480,050	35%	\$400,000–\$600,000
39%	\$480,050 and up	37%	\$600,000 and up

As an example, under the pre-TCJA rules, a married couple with AGI of \$500,000 in 2018 would have had \$142,024.50 of income tax with an effective rate of 28.4% before TCJA. The introduction of TCJA reduced that to \$126,379 of tax (a reduction of \$15,645.50) and an effective rate of 25.28% (3.13% less). That’s what we mean by saying that taxes are “on sale” under TCJA.<sup>2</sup>

**Secure Act.** The SECURE Act was passed in 2019 and became effective law as of Jan 1, 2020. Among other things, the SECURE Act eliminated the stretch IRA rules for inherited IRAs and replaced it with a new 10-year rule for the beneficiaries of inherited IRAs (other than spouses or minors). Recent commentary from the IRS (in the form of Proposed Treasury Regulations issued on Feb 23, 2022) on the rules make it clear that the 10-year rule applies to both traditional and Roth accounts, but its application is different. The application of the 10-year rule for Traditional IRAs requires some annual RMD each of those 10 years, whereas the Roth has no RMD in years 1-9 and just requires the entire inherited Roth be distributed by the 10<sup>th</sup> anniversary of the original Roth IRA owner’s death. The wealth transfer consideration for Roth IRA owners is that the inherited Roth IRA beneficiaries get the benefit of an additional 10 years of tax-free accumulation in that Roth IRA. One note is that the Roth must have a designated beneficiary, or else the rule changes from 10 years to 5 years.

**What’s Our Point?** The point is that TCJA makes the income tax consequences of Roth conversion (or the recognition of any other income for that matter) cheaper now than it will be in 2026, independent of market values or any other variables. And the SECURE Act’s elimination of the stretch IRA rules (and the IRS’ application of that change) make it far more beneficial from a wealth transfer perspective to convert to a Roth.

**Basics of a Roth Conversion.** The basic concept behind a Roth conversion is that the account owner converts assets titled in a Traditional IRA (or 401k) to a Roth IRA. The key differences between the two types of IRAs are important to understand as a preliminary matter. The notion of “short term pain for long term gain” resonates for this concept.

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<sup>2</sup> Note – these figures ignore standard deductions and other unique tax attributes that might be eligible for taxpayers.

### Traditional IRA basics:

- Typically funded with pre-tax dollars,
- Enjoys tax-deferred accumulation for several years,
- Begins to have required minimum distributions (RMDs) at age 72, which distributions are taxable as ordinary income at the income tax rates and brackets applicable in that year,
- RMDs continue for inherited beneficiaries during the 10-year period between death and the ultimate distribution at the beneficiary's income tax rate, and
- Contributions to a traditional IRA reduce the taxpayer's AGI in the year of the contribution.

### Roth IRA basics:

- Typically funded with after-tax dollars,
- Enjoys tax-free accumulation,
- Has no RMDs until 10 years after death,
- Distributions are not taxable when taken (including during the 10-year period from the owner's death), and
- Contributions to a Roth IRA yield no immediate income tax benefit in the year of contribution.

### **Income Tax Aspects of a Roth Conversion**

First, it's important to note that any assets converted from a traditional or tax-deferred retirement account into a Roth will trigger income tax on the amount converted. Remember that the traditional account was funded with pre-tax dollars, so a conversion means that the IRS will want its pound of flesh at that time. This aspect is relevant to why, all other things being equal, bear markets present opportune time for a Roth conversion; the temporary loss in traditional IRA values means the income tax burden for the conversion is less than it would have been when the equity markets were at all-time highs.

The hidden wealth transfer benefit of a Roth conversion triggering income tax is that the income tax payment for the conversion results in a reduction in the asset base of the taxpayer during his or her life (which will be subject to estate taxation at death). If they anticipate having a taxable estate, then the 40% estate tax they would owe on that balance is eliminated. Because even the highest federal income tax bracket is less than 40%, that is a positive arbitrage in and of itself, even if the death were to occur in the year after the conversion.

Finally, if you have tax losses to harvest in your taxable portfolio simultaneously with the Roth conversion (thanks to the current market environment), that can help offset the income tax liability of the conversion itself. It's worth noting that long-term capital losses (losses when you've held the investment for more than one year) only offer a modest ability to offset \$3,000 of ordinary gain with capital losses. But if you have short-term capital losses, then those are available to use against ordinary income (once it's been applied against capital gains).

Some taxpayers may wish to do partial Roth conversions over several years, and reverse engineer the amount of the partial conversion by trying to "top off" the marginal

income tax bracket for the tax year. Using the chart above as an example, if a married couple in 2022 anticipates their total AGI to be \$220,000 (squarely in the middle of the 28% bracket), they may decide to convert \$95,000 of an IRA, which fills up the balance of the 28% bracket without subjecting any income to 33%. While the effective tax rate will increase by virtue of more assets being subjected to 28%, no income will be taxed at 33%. This is often an approach that attempts to smooth out the income tax impact of Roth conversions. But it does somewhat myopically ignore other circumstances, like market forces for example.

### **What Are Some Limitations of a Roth Conversion**

One thing to note is that Medicare beneficiaries may find an unexpected cost of a Roth conversion for a year or two. If the conversion pushes the Medicare beneficiary's taxable income above a certain threshold, they will pay an income-adjusted surcharge on Part B premiums for at least a year.

A Roth conversion triggers the recognition of income taxes on the converted amount, at a zero basis. So before a conversion is done, in part or in full, it is prudent to anticipate the amount of the resulting income tax liability and also have a plan for the funding source of that liability.

There's no room for buyer's remorse with a Roth conversion. Unlike a marriage, it cannot be reversed or undone. As well, there is a 5-year rule against withdrawals for assets converted into or contributed to a Roth. So, someone approaching retirement who intends to fund living expenses from their IRA within 5 years would face penalties for withdrawing any converted amounts in 5 years.

Chances are that the IRA owner already has a high effective tax rate. Converting traditional IRA assets will just exacerbate that if the conversion hits the higher/highest income tax brackets. If the owner anticipates having much lower income in later years, then waiting to convert then might lessen the cumulative income tax liability over the life of the owner.

### **The Hidden Gift – Wealth Transfer Aspects of a Roth Conversion**

The differences in the types of IRAs and the elimination of the stretch rules for inherited IRAs mean that a conversion during life (for someone who will have a taxable estate) provides the downstream beneficiaries with hidden gifts in two ways. First, it means that the income tax liability for distributions from the IRA are borne by the IRA owner, and the tax burden is paid at income tax rates that are, for the moment, discounted to what they will likely be in 2026 and beyond. Second, it means that the IRA owner reduces his or her taxable estate by the amount of that income tax payment. Third, it allows the inherited IRA beneficiary an extra 10 years of tax-free appreciation after the death of the owner.

Congress got what they wanted with the SECURE Act, which was to make traditional IRAs a poor vehicle for estate planning. A perhaps unintended consequence is that Congress also increased the incentive for high-net-worth taxpayers to consider a Roth conversion. A lot of Roth conversions now will benefit today's federal coffers by pulling forward some tax recognition, which is basically like short term gain for long term pain. Has there ever been

something more accurate to summarize the decisioning of our federal government in this day and age?

Put simply, if you do not anticipate needing the RMDs from a traditional IRA to support your lifestyle, if you anticipate continuing to have substantial taxable income during your later years, and you anticipate having significant assets to pass down to children and grandchildren at your death, then a Roth conversion is likely something worthy of further analysis. And the timing of lower markets, an approaching sunset of income tax cuts, and changes to the inherited IRA rules combine to make now a good time to begin that analysis.

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