Roth IRA Conversions

BY CWG ADVISORS JULY 2020

With the lure of tax-free distributions, Roth IRAs have become popular retirement savings vehicles. According to the 2020 Investment Company Fact Book, about 19.4% of U.S. households owned Roth IRAs in 2019. One way to fund a Roth IRA is to convert some or all of your IRA or retirement plan money to a Roth IRA.

Roth IRAs - Background

There are three ways to fund a Roth IRA - you can contribute dirctly, you can convert all or a part of a traditional IRA to a Roth IRA, or you can roll funds over from an eligible employer retirement plan.
In general, you can contribute up to $6,000 to an IRA (traditional, Roth, or a combination of both) in 2020 ($7,000 if you're age 50 or older), or your taxable compensation for the year, if your compensation was less than this dollar limit. Your ability to make annual contributions may be limited (or eliminated) depending on your income level ("modified adjusted gross income," or MAGI), as show in the chart below:

Tax advisors say you can reduce your tax bill by 30% to 40% in this unprecedented time. (Source: 2020 Kiplinger article: "A Great Year for Roth Conversion)

If your filing status is...	**And your modified AGI is...**	**Then you can contribute...**
Married filing jointly or **qualifying widow(er)**	< $196,000 ≥ $196,000 but <$206,000 ≥ $206,000	Up to the limit A reduced amount Zero
Married filing separately and you lived with your spouse at any time during the year	< $10,000 ≥ $10,000	A reduced amount Zero
Single, head of household, or **married filing separately** and you did not live with your spouse at any time during the year	<$124,000 ≥ $124,000 but < $139,000 ≥ $139,000	Up to the limit A reduced amount Zero

Unlike a traditional IRA, you can contribute to a Roth IRA even if you're 701/2 or older. However, your contributions generally can't exceed your earned income for the year (special rules apply to spousal Roth IRAs).

2020 Impact to Roth Conversions

With stock market functions and the waiver of Required Minimum Distributions (RMDs) in 2020, it has become an ideal time to convert retirement savings from a traditional IRA to a Roth IRA. The financial fallout from the COVID-19 crisis has provided a once-in-a-lifetime opportunity to do Roth conversions at an affordable tax cost and gain some insurance against future tax rate increases. Say you are single and expect your 2020 taxable income to be about $100,000. Your marginal federal income tax bracket for this year is 24%. Converting a $200,000 tradi-tional IRA into a Roth account this year would cause most of the extra income from converting to be taxed at 32% and 35%.

3 Reasons why it may be the best time to convert a traditional IRA into a Roth IRA:

1. Low current tax rates
2. Your 2020 tax rate might be much lower than usual
3. Lower IRA balance after stock market

How do you convert a traditional IRA to a Roth?

Start by notifying your existing IRA trustee or custodian that you want to convert all or part of your traditional IRA to a Roth IRA, and the custodian/trustee will provide you with the necessary paperwork. You can also open a new Roth IRA at a different financial institution, and then have the funds in your traditional IRA transferred directly to your new Roth IRA. The trustee/custodian of your new Roth IRA can give you the required paperwork. If you prefer, you can instead contact the trustee/custodian of your traditional IRA, have the funds in your traditional IRA distributed to you, and then roll those funds over to your new Roth IRA within 60 days of the distribution. The income tax consequences are the same regardless of the method you choose.

Pro-Rata rule

If you look at how the IRS accounts for after-tax and pre-tax funds in an IRA when the taxpayer is doing a partial Roth conversion, this is reffered to as the pro-rata rule.The pro-rate rule is used to determine the after-tax amount of a Roth conversion when the taxpayer has both pre-tax and after-tax balances in their IRA(s). Composed sponsor plans like 401(k)s and 403(b)s are not used in pro-rata calculation, unless rolled over to an IRA in the year of conversion. (Source:2018 Rodgers & Associates: Converting an IRA to a Roth IRA? Know the Pro-Rate Rule")

Calculating the Pro-rata

When you take the total after-tax money in all IRAs divided by total value of all IRAs multiplied by the amount converted you end up with the formula for the pro-rata calculation.

For example, a taxpayer makes three $5,000 non-deductible contributions to an IRA over the past couple of years (a total of $15,000). The IRA is now worth $20,000, including growth. Additionally, the taxpaper also has an IRA Rollover account that is worth $80,000. When he or she converts the $20,000 IRA to a Roth, $3,000 will be considered after-tax and $17,000 will be considered pre-tax. ($15,000 divided by $100,000 = 15%; $20,000 x 15% = 3,000) (Source: 2018 Rodgers & Associates: Converting an IRA to a Roth IRA? Know the Pro-Rate Rule")

CARES Act Impact to Roth Conversions

Normally, IRA distributions are penalized if taken before age 59 1/2. Due to the CARES Act, there will be no penalty for hardship distributions. If you or your spouse has contracted the virus or you have been financially affected by it, you are eligible for a distribution. The 10% early withdrawal penalty is there to ensure your IRA funds remain in the account until you are older. However, due to the financial crisis, the penalty has been waived so you can get to your funds easier.

The CARES Act also gives some relief as to the taxes due. All traditional distributions are taxed when taken. All Roth IRA distributions before age 59 1/2 will have taxes due on the earnings (contributions are always tax free). The CARES Act will allow you to pay taxes over the next three years. You may choose to spread those taxes over several years.

One more important provision for IRAs due to the CARES Act are the contribution rules and the ability to repay your distribution. Normally, there's an annual limit to the amount you amy contribute to your IRA. For 2020, recall that limit is $6,000 or $7,000 if you are at least the age of 50. But, if you take a hardship distribution from your IRA, you may choose to re-contribute the entire amount, no amtter how large. Therefore, the annual limits will not apply if you repay the money withdrawn from the plan. Secondly, the CARES Act allows the ability to repay your distribution because zero taxes will be due if you put the entire amount of funds you withdrew back into the IRA (or other retirement plan). Essentially, this allows you to take a loan from your IRA, which is normally against the rules.

Employer retirement plans

You can also roll over non-Roth funds from an employer plan (such as a 401(k)) to a Roth IRA. Like traditional IRA conversions, the amount you convert will be subject to income tax in the year of conversion (excpet for any after-tax contributions you've made).

Is Roth conversion right for you?

The answer to this question depends on many factors, including your current and projected future income tax rates, the length of time you can leave the funds in the Roth IRA without taking qithdrawls, your state's tax laws, and how you'll pay the income taxes due at the time of the conversion.

If you meet one or more of these criteria, consider a Roth conversion in 2020:

•Your IRA balance is over $500,000.

•You are over age 70½ (or turned 72 in 2020), and do not have to take your required minimum distribution (RMD) in 2020.

•You expect your 2020 taxable income to be lower than your 2019 taxable income.

•You are in the 24% or 32% tax bracket.

•You can pay the taxes on a Roth conversion from your

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