Roth Conversions in Volatile Markets

As investors weather a tumultuous market in the first quarter of 2022, the current volatility may pose an opportunity for IRA account holders. Those who hold IRA accounts (and 401(k) accounts that allow for Roth conversion) may wish to speak with their wealth manager about whether it may be advantageous to convert a portion of their pre-tax qualified plans to Roth. There are four main reasons why current market conditions are favorable for Roth conversion planning:

1. **Current market Condition:** Converting a pre-tax Traditional IRA to a Roth IRA will result in taxable income based upon the fair market value of the assets in the IRA at the time of conversion. However, once the account is converted to a Roth IRA, current law allows any future growth to be withdrawn income tax-free, so long as the account owner is at least 59 ½ years old and has had at least one Roth IRA opened for five years on the date of withdrawal. Thus, it may be advantageous to utilize a Roth conversion at a time when markets are down and the tax liability will be based off a lower valuation.

   For example, if an individual in the 24% Federal tax bracket converts a $100,000 Traditional IRA to a Roth IRA, her taxable income for the year will increase by $100,000. Assuming she remains in the 24% bracket with this additional $100,000 of income, she would owe roughly $24,000 in federal taxes at the time of conversion. If a market correction reduces her account balance by 20% and she converts the account at an $80,000 value, her federal income tax from the conversion would fall to $19,200, yielding a $4,800 tax savings. Once the funds are held inside a Roth IRA, any future market rebound and appreciation will be free of tax.

2. **Possibility of Tax Increase:** Absent Congressional action, reduced tax brackets initiated by the Tax Cuts and Jobs Act (TCJA) in 2018 will sunset on January 1, 2026. The chart below illustrates the reduced tax rates brought on by the TCJA.

Current Federal Tax Brackets vs. Anticipated 2026 Tax Brackets							
Pre-2018 Federal Tax Brackets (scheduled to resume in 2026)	10%	15%	25%	28%	33%	35%	39.6%
2022 Federal Tax Brackets	10%	12%	22%	24%	32%	35%	37%

Unless Congress changes the 2022 tax brackets through tax reform, converting a Traditional IRA to Roth in 2022 could result in a lower marginal Federal tax rate than would be applied in 2026 or later. Given that Traditional IRA accounts are subject to Required Minimum Distributions, it may be advantageous to consider converting a portion of the IRA to Roth while tax rates are reduced.

3. Pay Taxes Out of Taxable Accounts: When converting Traditional IRA accounts to Roth IRAs, it is typically most efficient to pay the resulting tax liability with cash or other taxable accounts, rather than withholding taxes from the IRA. In this way, the entire balance being converted to Roth can continue to grow tax-free (rather than a portion being withdrawn to cover taxes).

4. Avoid Required Minimum Distributions: Under current law, holders of Traditional IRA accounts are required to take annual distributions from their IRAs beginning the year after they turn 72. Unlike Traditional IRAs, a Roth IRA currently does not have Required Minimum Distributions. Converting an IRA to Roth would allow the account holder to continue growing their retirement account without any need to take Required Minimum Distributions.

Other Considerations

The decision to convert all or a portion of your pre-tax IRA accounts depends upon an individual's own facts and circumstances. Taxpayers are advised to speak with their tax and financial advisors prior to undertaking a Roth conversion. The following are a list of other common considerations when deciding whether to convert a portion or all of an IRA to Roth.

1. State and Local Taxes: Roth conversions will increase taxable income in the year of conversion, which will also increase state and local taxes. Taxpayers should consider their retirement goals before converting to Roth. If an individual currently resides in a high tax state but plans to retire in a state without income taxes, there is a likely disincentive to convert to Roth now. Furthermore, state and local taxes paid are currently deductible only up to $10,000 for federal tax purposes. Absent Congressional action, state and local taxes paid will be fully deductible in 2026 (subject to the Alternative Minimum Tax).

2. Current vs. Retirement Tax Brackets Tax Bracket in Retirement: For individuals still in their earning years, consideration should be given to their projected income tax bracket in retirement. For example, a taxpayer presently in the top tax bracket may be in a lower tax bracket during retirement, even with the scheduled increase in tax brackets.

3. Legislative Risk: While Roth IRA accounts are presently income tax-free upon distribution, and are not subject to Required Minimum Distributions, there have been some legislative efforts to limit Roth IRAs. For example, there is a risk that Congress may change the laws in the future, so that taxpayers in higher tax brackets must pay tax on Roth earnings or Required Minimum

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Distributions must be taken from Roth IRAs. Summit continues to monitor tax proposals and will provide updates as appropriate.

4. Cash Flow Planning to Pay Tax Liability: As mentioned previously, the taxes triggered by a Roth conversion may be paid out of after-tax accounts, allowing the entire IRA being converted to continue to grow income tax-free. Individuals looking to convert their Traditional IRA to a Roth IRA should understand the tax implications of a conversion and how much additional tax liability will be generated.

In sum, there are many reasons an investor today should consider a Roth IRA conversion. However, one must consult with a financial advisor equipped to understand the individual's entire financial picture to determine whether this strategy may be appropriate.

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