Should you convert to a Roth before year-end?

With big changes proposed for Roth conversions, time may be of the essence.

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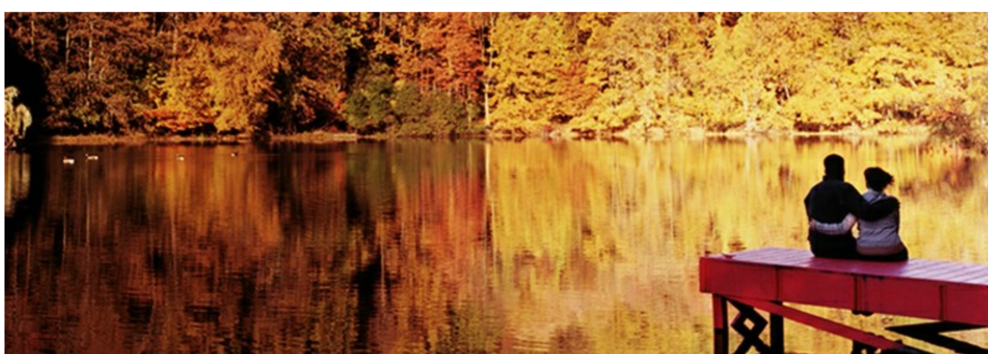

Key takeaways

- Proposed legislation would prohibit the conversion of after-tax assets in traditional IRAs and employer-sponsored retirement plans into Roth accounts after December 31, 2021.
- Before accelerating plans for a Roth conversion, be sure to fully understand the impact it could have on your overall financial situation, from taxes to estate planning.
- It's still not certain that these new restrictions will become law, so before making a move, consult with your tax advisor and accountant to weigh your options.

Since 2010, high-income investors looking for tax-free growth potential and tax-free withdrawals in retirement have had the option of converting assets in their traditional IRA or employer-sponsored retirement plan to a Roth IRA. However, legislation currently under consideration in Washington would place new restrictions on this technique. If the legislation is enacted, conversion of after-tax assets would be prohibited for all investors after December 31, 2021, regardless of income level. Additionally, under the latest proposal, those whose incomes place them in the highest federal bracket would be unable to convert even pre-tax balances to Roth accounts after 2031.

If you were planning on converting after-tax assets to a Roth IRA, time may be of the essence. But does it really make sense to accelerate your plans for a Roth conversion to get in under the December 31 deadline? Before making a decision, it's important to consider these critical factors.

Are you prepared to pay now?

When converting a traditional IRA with nondeductible assets to a Roth IRA, you will likely also have to convert a portion of your deductible balances as well, which means some taxes will be owed at the time of conversion. The rules that govern how much of the nondeductible contributions you can convert can be complex, especially if you have multiple IRAs.

Any deductible assets included in a Roth conversion will be treated as income for the current tax year, increasing your adjusted gross income (AGI). While some investors may be able to offset this tax liability with charitable giving and tax-deductible losses, most will need to pay it with cash on hand. If you have to tap into the assets you are converting or sell other investments to cover the bill, it may not be worth the trouble.

On the other hand, if you've experienced an unusual dip in income over the last year or have the ability to implement a strategy to reduce your taxable income such as donating complex assets or accelerating planned charitable donations into the current year, this may be a good opportunity to consider a Roth conversion, as the increase in AGI is less likely to push you into a higher tax bracket.

Do you plan on moving soon?

If you have plans to move to a state where future distributions from a traditional IRA or employer-sponsored retirement plan will be taxed at a higher rate, such as California, it could be advantageous to do the Roth conversion before you relocate. "On the flip side," says Joel Friedlander, a partner at Ernst & Young, "maybe you're moving from California to Texas; the tax cost of converting to a Roth may not be worth it because those future distributions would not be taxable in your resident state of Texas."

Do you want to protect your inheritors from taxes?

"The Roth conversion can be quite valuable, not only from an income tax perspective, but also from an estate tax perspective," says Bryan Hwang, a vice president with Fidelity's Advanced Planning group.

Following the passage of the SECURE Act, those who inherit a Roth or traditional IRA or a 401(k) must completely withdraw all funds from the account within 10 years of the death of the original account holder, with exceptions for eligible designated beneficiaries (defined as surviving spouses, minor children, disabled or chronically ill beneficiaries, or beneficiaries who are less than 10 years younger than the original account holder). Prior to this, inheritors could stretch out withdrawals over their lifetime, taking only yearly required minimum distributions and benefiting from additional growth in the account.

Now, however, those who inherit traditional IRAs or 401(k)s are likely to pay more in taxes as they must make larger withdrawals over a shorter period. Converting those assets to a Roth IRA would protect inheritors from federal taxes, greatly increasing the potential for additional tax-free growth.

Backdoor Roth conversions

The proposed legislation would also eliminate the so-called "backdoor" Roth conversion, which allows individuals who earn too much money to directly contribute to a Roth IRA to fund one regardless.

This is achieved by first contributing after-tax dollars to a traditional IRA or 401(k), then immediately converting it to a Roth IRA. As the assets have not been in the original account for very long, it's likely that the tax due at the time of conversion would be minimal, if not nonexistent (assuming you do not have multiple IRAs). While there are income limits on Roth contributions, there have been no such limits for Roth conversions, making this a popular strategy for high-income investors.

"The current tax bill proposes to eliminate the ability to do this immediate conversion of a contribution, even if you're not phased out of the ability to convert to a Roth based on your current income levels," says Friedlander.

Consult a tax professional

Though Washington has set an aggressive timeline for these potential changes, it's important not to rush into any decision before fully considering the impact accelerating your Roth conversion could have on your overall wealth plan. At present, the situation in Congress is still quite fluid, and it's not clear which provisions of the proposed legislation will be included in the final bill. Moving too quickly could result in missteps that undermine the tax-efficiency of your overall strategy. Before you determine your next step, consult with your tax advisor and accountant and work together to identify the best approach for your specific situation.

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