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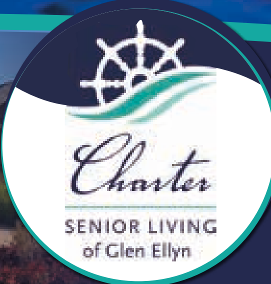

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Roth Rethink

By Erik Ford

financial fitness

It can be difficult to keep up with changing tax rules, including as it relates to estate and investment planning. In the past, depending on your success in saving for your retirement, you may have included passing unused IRA funds on to your designated heirs. Under the previous rule, this was part of many planning strategies because the IRA beneficiary was able to take the funds out over time (the "stretch IRA") through required minimum distributions (RMDs) and perhaps even pass that benefit on to further heirs, maximizing the tax deferral benefits of the traditional IRA. This tax deferral opportunity was valuable as traditional IRA withdrawals are taxed as ordinary income. Spouses could, and still can, roll an inherited IRA into their own name.

The passage of the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) changed all that for IRAs passed on to beneficiaries after the effective date of the act. The SECURE Act eliminated the requirement to take RMDs in the inherited IRA but added the requirement that the inherited IRA balances be withdrawn (and taxed) within 10 years of being inherited. By not being able to extend the tax deferral benefits of the traditional IRA beyond 10 years, beneficiaries will face the tax bills on the entire IRA and the benefits of tax deferral end after 10 years. There are several specific exceptions to this 10-year rule depending on the age and health status of the beneficiary.

As a result of this change, making a Roth conversion during the lifetime of the original IRA account holder may become a more attractive alternative than previously. By converting a traditional IRA to a Roth IRA, the original IRA holder can control when taxes are paid and pay the taxes themselves rather than put that tax obligation on the beneficiary. This can have positive financial benefits if the original IRA owner converts the traditional IRA to the Roth (and pays the taxes on conversion) while in retirement. The conversion (and taxes) may be spread over several years at a time when their tax rate may be lower, rather than placing that burden on the beneficiary, who may be still working and in a higher tax bracket. A further benefit to the original account holder is the Roth IRAs are not subject to required minimum distributions to the original account holder.

As a quick review of the math behind the traditional IRA/Roth IRA comparison, the difference comes down to a comparison of tax rates. With a Roth IRA, the taxes are essentially paid upfront (contributions are made with after-tax dollars) and subsequent gains are not taxed on withdrawal. With the traditional IRA, you take an income tax deduction on contributions and all distributions are taxed as ordinary income when withdrawn. If you assume the investment returns are identical, the Roth is the better alternative if your tax rates are lower when you put the money into the Roth IRA than when you take the money out. Therefore, if a traditional IRA holder has a lower tax rate in retirement because they are no longer working, paying the tax on a Roth conversion may be beneficial to an eventual beneficiary. The Roth IRA can be withdrawn or kept for as long as ten years by the beneficiary without incurring any taxes on withdrawal, giving the beneficiary much more flexibility, free of tax implications.

Of course, it is best to consult professional tax and investment advisors before determining what may be in your own best interest.

Erik Ford is the owner of Ford Wealth Management LLC in Glen Ellyn, IL. He is a CFP® certificate holder as well as an accredited investment fiduciary®. Registered representative. Securities offered through Cambridge Investment Research Inc., a broker-dealer, member FINRA/SIPC.

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