

A WINDOW OF OPPORTUNITY

An Optimal Environment for Roth Conversions

The fallout from the COVID-19 pandemic will likely result in lower incomes for millions of Americans this year. In addition, many individuals have experienced a sharp decline in their retirement plan balances. While never sought after, such outcomes do present a unique, long-term planning opportunity. Those affected can enhance tax efficiency and accumulate wealth by converting a portion of a traditional retirement plan to a Roth 401(k) or Roth IRA.

TODAY'S ENVIRONMENT OFFERS AN OPENING

Many individuals will have lower taxable income this year as a result of the current economic and business environment.¹ For some, the year-over-year decline will be temporary—a result of compensation cuts, furloughs, and business slowdowns. For others, the drop will stem from reduced rental income, lower capital gains, and the reprieve from required minimum distributions (RMDs) this year.² At the same time, retirement plan values have contracted sharply, reflecting the US equity market's fall from February's all-time high.³

While these conditions may sound like a proverbial “door closing,” they open a window for a Roth conversion, for two main reasons:

- **Lower asset values:** Participants must pay ordinary income tax on the fair market value of converted assets.⁴ So, the recent fall in asset values provides a lower base on which to impose taxes. This is especially timely since the Tax Cuts and Jobs Act (TCJA) of 2017 eliminated “recharacterization” of Roth conversions.⁵ Before the law, the ability to recharacterize reduced the timing risk of converting—effectively giving participants a “mulligan” if the converted assets declined in value. With that possibility now eliminated, converting today, after a sizeable decline in asset values, seems much more favorable compared to converting at the height of the longest bull market in history.⁶
- **Lower effective tax rate:** A reduction in income—even if temporary—will likely lower an individual's effective tax rate and make the cost of conversion cheaper. In addition, the Coronavirus Aid, Relief, and Economic Security (CARES) Act removed the AGI limitation on cash gifts to certain charities this year.⁷ In fact, there's a rare opportunity to convert to a Roth without any tax costs: Without this AGI limitation this year, large enough donations could trigger a tax-free conversion. However, the Act explicitly excludes gifts to donor-advised funds, private foundations, and supporting organizations from this special treatment.⁸

Importantly, the tax rate paid at conversion relative to future rates heavily influences the benefits of converting. An ideal Roth conversion would occur at a lower tax rate relative to the rate at which future IRA withdrawals would have been subject, assuming no conversion took place.

As currently legislated by the TCJA, the current income tax brackets are scheduled to sunset after 2025, leading to higher marginal rates in 2026.⁹ Furthermore, the massive amounts of deficit spending triggered by this crisis will put upward pressure on tax rates. Could the government's need to raise future revenue compel Congress to impose a tax on large Roth account balances? Possibly.¹⁰ Given that risk, those concerned with future legislation may opt for a partial, rather than full conversion. This will serve as an effective risk hedge while taking advantage of today's ideal environment.

¹ See U.S. Department of Labor, Bureau of Labor Statistics News Release, April 3, 2020. (“Total nonfarm payroll employment fell by 701,000 in March, and the unemployment rate rose to 4.4 percent. The changes in these measures reflect the effects of the coronavirus (COVID-19) and efforts to contain it.”)

² For those over 70½ or beneficiaries of inherited retirement accounts. Section 2203(a) of P.L. 116-136 (“CARES Act”) waives required minimum distributions for 2020.

³ The S&P 500 was down 23.7% from its peak on February 19, 2020 through March 31, 2020.

⁴ Treas. Reg. § 1.408A-4(A-1)(c).

⁵ Section 13611 of P.L. 115-97 (“TCJA”).

⁶ The S&P 500 was down 24.2% from January 2, 2020 to April 1, 2020. The S&P 500 was up 408% from March 6, 2009 to its peak on February 19, 2020.

⁷ CARES Act, Section 2205(a).

⁸ CARES Act, Section 2205(a)(3)(B).

⁹ TCJA, Section 11001(a).

¹⁰ For example, the Tax Reform Act of 1986 included the excess distribution and excess accumulation tax provisions. The excess distribution provision under Section 4980A of the Internal Revenue Code imposed a 15% additional tax on withdrawals from qualified pension plans exceeding \$150,000 per year. Section 4980A was repealed by P.L. 105-34, Section 1073(a), effective for excess distributions received after December 31, 1996.

HOW BENEFICIAL IS A ROTH CONVERSION?

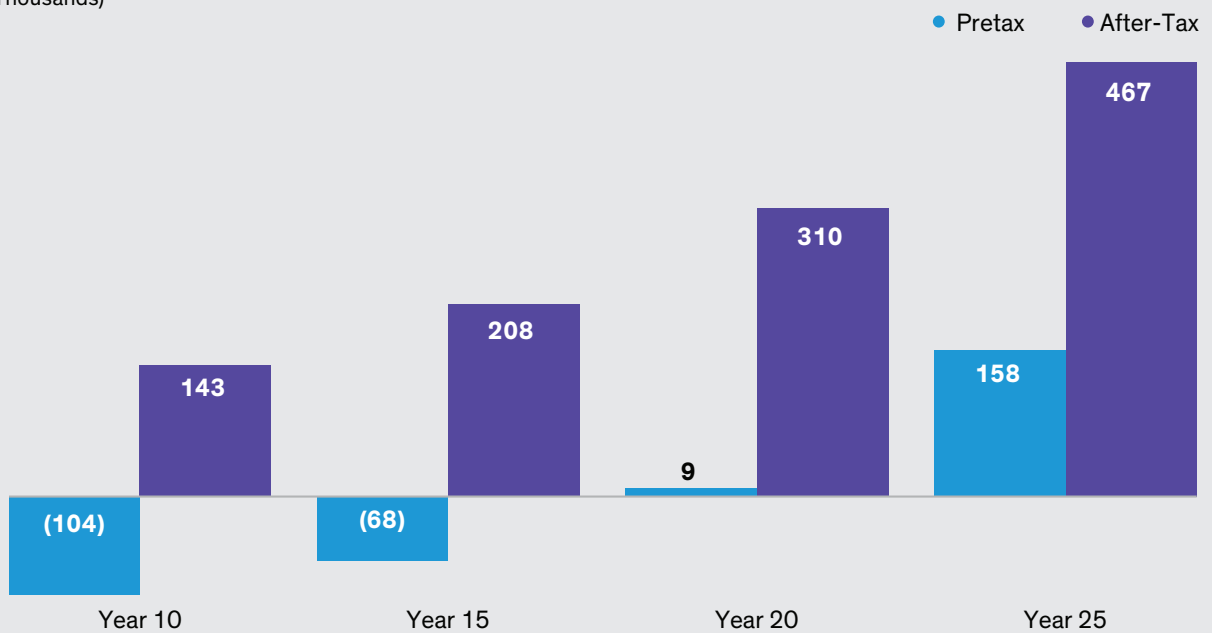
In the optimal situation, where the tax rate at the time of conversion is much lower than the future rate at the time of distribution, a Roth conversion can be significantly beneficial. To quantify the advantage, consider the following:

A 62-year-old participant with no other taxable income this year considers converting \$350,000 of his IRA. The Roth conversion would cost him \$67,000 in federal tax, which he'd pay using non-IRA assets. If he forgoes the conversion, RMDs must begin in 10 years, at age 72,¹¹ which we assume would be taxed at the top marginal ordinary-income tax rate.

Over the next 25 years, we project the Roth will grow to approximately \$1.7 million, compared to approximately \$1.2 million of after-tax wealth in the no-conversion scenario (in the median case). In other words, the conversion provides \$467,000, or 38% more after-tax wealth, than the traditional IRA (*Display 1*).

DISPLAY 1: BENEFIT OF A ROTH CONVERSION OVER TIME

**Relative Benefit of \$350,000
Roth Conversion vs. No Conversion**
Nominal (USD Thousands)



Relative After-Tax Benefit	29%	32%	35%	38%
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For illustrative purposes only. Data do not represent past performance. Actual returns may be higher or lower than projected.

The chart displays the difference in pretax and after-tax values over 10, 15, 20, and 25 years resulting from a \$350,000 conversion of a traditional IRA to a Roth IRA in 2020 assuming: (1) participant is 62 years old and will begin required distributions at age 72, (2) in the year of Roth conversion, the participant has zero taxable income, other than the conversion, and the income tax on conversion is \$67,000, (3) the participant will be subject to the top marginal federal tax rate in every future year, (4) all assets are invested 80% equities and 20% fixed income, including the initial tax savings of \$67,000 in the no-conversion scenario, and (5) pretax amounts reflect projected account balances, while the after-tax amounts reflect the amount available after fully distributing the traditional IRA in the indicated year of the analysis.

Projections based on Bernstein's estimates of the range of returns for the applicable capital markets. Data do not represent past performance and are not a promise of actual results or a range of future results. See Notes on Wealth Forecasting System for details.

Source: AllianceBernstein (AB)

¹¹ Internal Revenue Code of 1986 ("I.R.C."), Section 401(a)(9)(C)(i)(I).

This scenario represents the best of all worlds: a low tax rate at conversion and a substantially higher projected future rate. However, a Roth conversion remains attractive even if the future rate is the same or slightly lower than the current one. In fact, our research shows that over a 25-year horizon, future tax rates would need to decline by more than seven percentage points before the benefit disappears. For example, a 24% effective tax rate at conversion could drop as low as 17% at distribution, or a 37% rate at conversion could fall to 30% at distribution, and the Roth conversion would still prove superior. This relationship holds true for time horizons of 20 years or longer in growth-oriented portfolios.

THE SECURE ACT: ARE ROTH CONVERSIONS LESS ATTRACTIVE NOW?

Roth conversions remain attractive even for beneficiaries who are no longer able to stretch inherited retirement accounts over their lifetime as a result of the SECURE Act.¹² In fact, while it may sound counterintuitive, the elimination of the stretch makes Roth conversions more compelling in some ways. While the ability to compound wealth tax-free over future beneficiaries' lifetimes was a benefit, it is certainly not a requirement for a conversion to be favorable. Let's walk through an example:

A participant in the highest income tax bracket is considering converting some or all of her \$1,000,000 traditional IRA. We modeled three scenarios covering no, partial, and full Roth conversions. Note that in Scenarios B and C, we deducted the tax cost of conversion from a taxable account that originally held an additional \$370,000 (*Display 2*):

- Scenario A: No Roth Conversion; \$1,000,000 traditional IRA; \$370,000 taxable account
- Scenario B: 50% Roth Conversion; \$500,000 traditional IRA; \$500,000 Roth IRA; \$185,000 taxable account
- Scenario C: 100% Roth Conversion; \$1,000,000 Roth IRA; \$0 taxable account

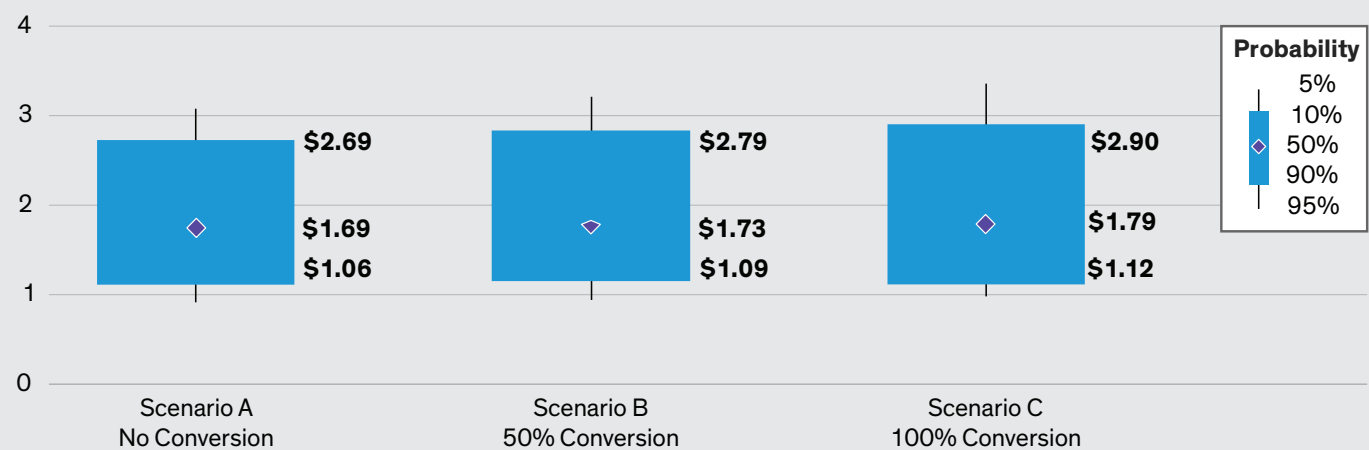
To stress-test each situation, we assumed the participant dies the day after converting the IRA and the beneficiaries defer distribution of the inherited retirement accounts for 10 years—the maximum length under current law.¹³

DISPLAY 2: ROTH CONVERSIONS CAN CREATE A BENEFIT IF TAX RATES DON'T CHANGE...

Beneficiary Is Top Marginal Taxpayer

After-Tax Range of Assets—Year 10*

Nominal (USD Millions)



For illustrative purposes only. Data do not represent past performance. Actual returns may be higher or lower than projected.

*Values assume designated beneficiary inherits the Traditional IRA and Roth IRA assets and satisfies required distribution as a lump sum in year 10. The beneficiary is assumed to be subject to top marginal tax rates and the portfolio is assumed to be allocated as 80% global stocks and 20% bonds. Based on Bernstein's estimates of median returns for applicable capital markets over the next 10 years. AB is not a legal, tax, estate, or insurance advisor. Investors should consult these professionals as appropriate before making any decisions.

Source: AB

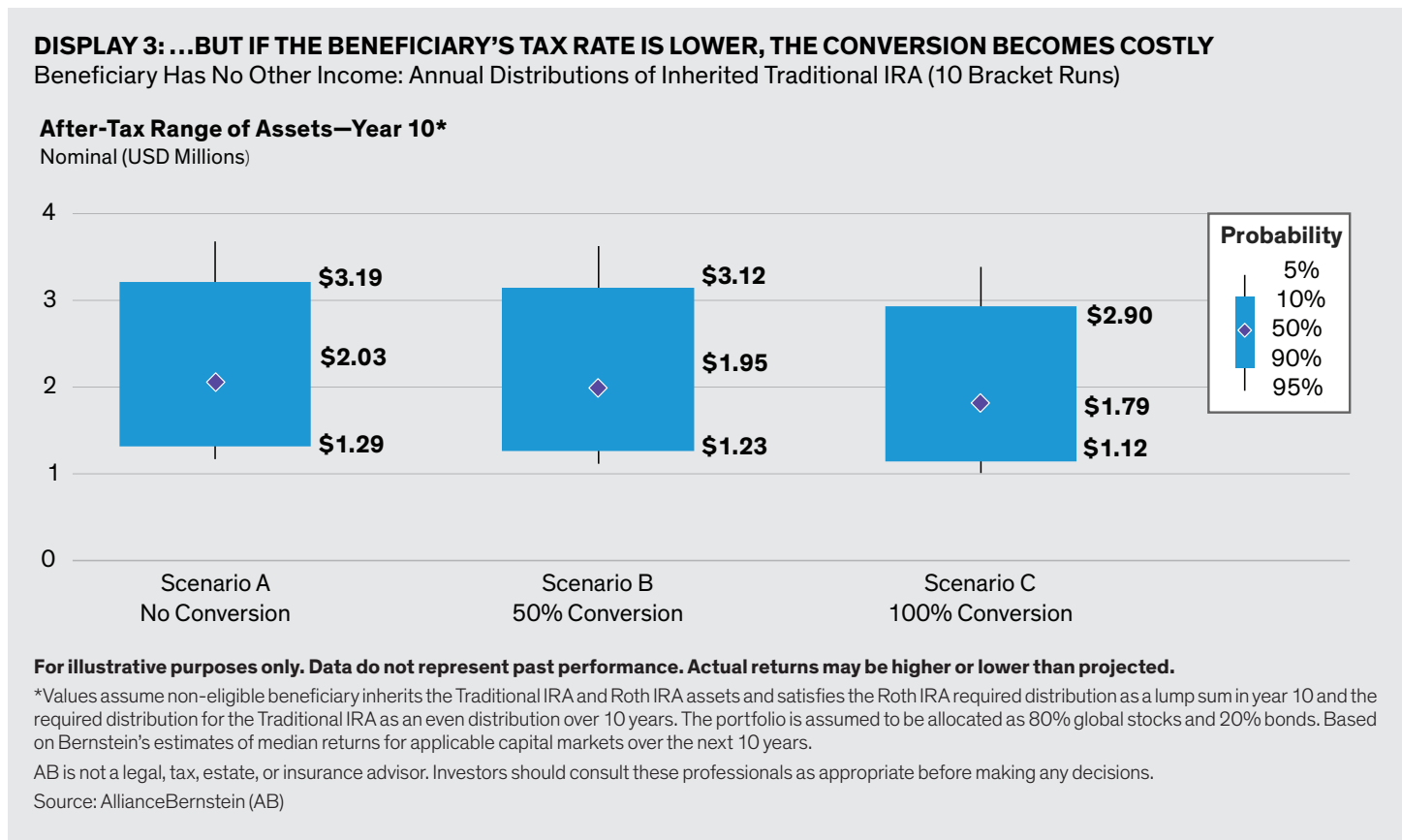
¹² P.L. 116-94 ("SECURE Act"), Section 401(a)(1).

¹³ SECURE Act, Section 401(a)(1).

Ten years after the participant's death, the 100% Roth conversion (Scenario C) produces approximately \$100,000 more wealth than the no Roth conversion (Scenario A), in the median case. This is impressive, especially considering the Roth IRA had no accumulation period during the participant's lifetime. In other words, the Roth conversion did not cost the family anything.

However, this may change for beneficiaries taxed at lower rates than the rate at which the IRA was converted. In the above analysis, we assumed the beneficiary is a top marginal taxpayer like the participant. The outcome changes if the beneficiary falls into a lower bracket.

To demonstrate, we assume the beneficiary has no other income and the traditional IRA is distributed in annual installments over 10 years. In this case, the no-conversion scenario ends up with \$240,000 more than the 100% conversion (Display 3). Distributing the IRA in annual installments over 10 years lowers the beneficiary's tax cost compared to receiving the entire traditional IRA in one year because the beneficiary essentially runs the tax brackets 10 times, allowing more income to be taxed at lower rates. The tax savings on a full bracket run for a single taxpayer can be more than \$35,000 per year.¹⁴ Therefore, a longer accumulation period during the participant's life would be required in order for converting to outperform.



Time horizon matters as well. How long would the participant need to live for the Roth conversion to benefit assuming the future beneficiary had no taxable income?

We found that if the participant lives at least 11 years after converting and the beneficiary allows the inherited Roth IRA to grow for an additional 10 years, then there's still a benefit, even if the participant falls into the top marginal tax bracket at conversion. And if the beneficiary has some taxable income, the participant's necessary survival time shortens even further.

¹⁴ The value of a full bracket run is calculated as the tax liability on \$518,400 of income taxed at the top marginal federal tax rate of 37% less the tax liability on \$518,400 of taxable income running through each of the tax brackets for a single tax filer.

THE CARES ACT ADDS FURTHER IMPETUS

The CARES Act waived RMDs for 2020 allowing additional tax deferral this year for those who can afford it. However, the Act did not actually become law until March 27, 2020, after some participants had already taken distributions. There are a couple of options available to these participants, depending on when the distribution was taken.

- **Distribution Rollover:** Normally, a participant has 60 days¹⁶ to return a retirement plan distribution, but IRS Notice 2020-23 extends the deadline until July 15, 2020, for distributions taken on or after February 1, 2020.¹⁷ While this doesn't help individuals who took distributions in January, it does provide relief for those who took them in February and March. But there's a catch: Only one IRA rollover is permitted within 12 months.¹⁸ So, if a rollover occurred within the last 365 days, this option disappears. However, the one-rollover-per-year rule does not apply for employer-sponsored plans, such as a 401(k)—it may be possible to roll multiple IRA distributions to these plans. To avoid tax on the original distribution altogether, the entire amount must be recontributed, including any tax withheld (the tax withholding will be a tax credit on the 2020 tax return). Moreover, the IRS may provide additional relief at a future date.¹⁹
- **Distribution Conversion:** Another option? Convert the distribution to a Roth instead of rolling it back to a traditional IRA. Normally, RMDs are not eligible for a Roth conversion. But with no RMDs this year, it's permissible. Unfortunately, this option also remains unavailable for January distributions. However, it may prove attractive if a rollover already occurred in the last year. Unlike a rollover, an unlimited number of Roth conversions can occur in a year.²⁰ For example, if a participant took a distribution in each of February, March, and April, only one of the distributions can be rolled back into the IRA. But all three can be converted into a Roth. Unlike a rollover, the entire distribution will be taxable, but converting to a Roth IRA will maximize tax-free growth.

TAKE ADVANTAGE OF LOW TAX RATES NOW

The current market environment has many drawbacks, but whenever possible, investors should exploit market weakness for future gain. Today is one of those opportunities. This negative-return, low-income landscape can make converting all or a portion of a traditional retirement account to a Roth advantageous. Whether you expect to be in a lower tax bracket than usual or are inclined to make a substantial cash gift to charity to satisfy growing societal needs, a small window of opportunity exists. If the conditions are right for you, consider taking advantage of the potential to grow future wealth.

¹⁵ CARES Act, Section 2203(a), waives required minimum distributions for 2020.

¹⁶ I.R.C. § 408(d)(3)(A).

¹⁷ Notice 2020-23 states: "The Secretary of the Treasury has also determined that any person performing a time-sensitive action listed in either § 301.7508A-1(c)(1)(iv)–(vi) of the Procedure and Administration Regulations or Revenue Procedure 2018-58, 2018-50 IRB 990 (December 10, 2018), which is due to be performed on or after April 1, 2020, and before July 15, 2020 (Specified Time-Sensitive Action), is an Affected Taxpayer." Revenue Procedure 2018-58 includes "Secs. 402(c), 403(a)(4), 403(b)(8), 408(d)(3), and 457(e)(16)(B)" as time-sensitive acts that may be postponed under sections 7508 and 7508A.

¹⁸ I.R.C. § 408(d)(3)(B).

¹⁹ For example, in 2009, the IRS issued Notice 2009-82 allowing an extended rollover deadline for "nonrequired required distributions."

²⁰ The 60-day rule still applies for Roth conversions.

The Bernstein Wealth Forecasting SystemSM uses a Monte Carlo model that simulates 10,000 plausible paths of return for each asset class and inflation and produces a probability distribution of outcomes. The model does not draw randomly from a set of historical returns to produce estimates for the future. Instead, the forecasts: (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of the analysis; and (4) factor in a reasonable degree of randomness and unpredictability. Moreover, actual future results may not meet Bernstein's estimates of the range of market returns, as these results are subject to a variety of economic, market, and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

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