The Triple Crown tax benefits of 2021 Roth conversions

With potential tax changes on the horizon, here are the IRA moves to make now.

BY ED SLOTT April 30, 2021

On the eve of this year's Kentucky Derby, the first of three races a horse must win to grab racing's Triple Crown, the Biden tax proposals are underscoring the triple crown of tax advantages provided by Roth conversions.

While the administration's tax plan is still far from becoming law, clients are already getting worried and asking advisers what they should do. In light of the tax increases being proposed on wealthier clients, it is crystal clear to me that Roth conversions should be evaluated with every client now.

For your higher-income clients, it's a pretty good bet that their tax rates will not be going down and are likely to increase at some point, not only based on the tax proposals being debated now but based on simple math — the national deficit and debt levels. These are at historically staggering amounts. At some point, these bills will have to be paid and that usually means higher taxes later, no matter who is in office.

When it comes to tax, retirement and estate planning, advisers must look beyond today's noise from Washington and plan with the long-term big picture in mind. That means, what can you do now to enhance your clients' financial security in retirement and beyond for their heirs.

When you look at it this way, the retirement tax moves to make now are easy to see. Take advantage of this year's low tax rates by ramping up Roth conversions. This moves clients' individual retirement accounts and 401(k)s from tax-deferred territory to tax-free for life.

Even after the SECURE Act eliminated the stretch IRA for most non-spouse beneficiaries, they still get to keep inherited Roth funds accumulating tax-free for up to 10 years after death. As future tax rates increase, Roth IRA funds (or any tax-free vehicle) become instantly more valuable, since they won't be eroded by future taxes at higher rates on higher balances.

The time to act is now because we already know what this year's tax rates are. As each day goes by, it becomes less likely that any tax reform that becomes law will be retroactive to Jan. 1, 2021, because we are too far into the year for that now. Any changes that might come will probably be effective in 2022, so 2021 is the year to make moves.

By converting in 2021, clients and their families receive a trifecta of tax benefits that all have staying power for the long run:

1. They lock in today's historically low tax rates. Higher earners will likely never see tax rates this low again for the rest of their lives.

2. They lock in a zero percent tax rate on those Roth funds for the rest of their life and their spouse's life, and for 10 years after death for their beneficiaries (possibly even longer for any eligible designated beneficiaries who still qualify for the stretch IRA). Plus, Roth IRA owners have no lifetime required minimum distributions, so if the funds are not needed, they can continue to accumulate tax-free for the rest of their life, no matter how high tax rates go.

3. They reduce future years' taxes since the funds converted will lower IRA balances and in turn, lower required minimum distributions, which means lower future taxes. It's true that for the year of the conversion, their income will spike and create an increased tax bill, but that is only for the year of the conversion. Avoiding taxes now on IRA distributions is short-sighted and clients will pay in the long run. Remind clients that if these taxes aren't paid now, they must be paid later and likely at a higher cost, leaving clients with less when they will need it most — in retirement, when the paychecks stop and they will be more vulnerable to tax increases.

In addition to the above trifecta of Roth conversion benefits, there are estate and gift tax advantages.

The current estate and gift tax exemption is $11.7 million ($23.4 million for a married couple), but that may be reduced drastically, possibly to as low as $3.5 million. This could expose some clients' estates to federal estate or gift taxes where they weren't before. While Roth IRAs can be income tax-free, they are still included in the estate. But paying tax now, especially on large Roth conversions, will reduce that estate value by the tax paid, leaving more for heirs, even net after any taxes paid on the Roth conversions now.

In fact, paying the tax to convert, even for older clients who, based on their age, would not personally benefit from a Roth conversion, would be the same as making a gift to their children or grandchildren, since in essence they are paying a tax that the heirs would have to pay if the conversion wasn't done. But paying the tax does not count as a gift for gift or estate tax purposes, so even if the gift or estate tax exemption is lowered, the Roth conversion is kind of an end-around move to make gifts that don't count as gifts. These Roth conversions can also lower state estate taxes, especially in those states that have much lower estate tax exemptions.

It's time to act now and play the long game. Roth conversions are a winning tax move considering possible tax law changes coming. It's the financial adviser's job to protect and preserve their clients' retirement funds. If they do, both the clients and advisers win.