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Abstract: The COVID-19 pandemic has been causing havoc in the global markets and the U.S. economy. In these uncertain times, it's important to stay on top of your financial status, including taking measures to protect your retirement nest egg over the long term. This article discusses what to consider when determining whether a Roth IRA conversion makes financial sense.

Is a Roth IRA conversion right for you this year?

The COVID-19 pandemic has been causing havoc in the global markets and the U.S. economy. In these uncertain times, it's important to stay on top of your financial status, including taking measures to protect your retirement nest egg over the long term. One idea to consider is converting a traditional IRA to a Roth IRA.

Traditional vs. Roth

First, let's review the key differences between traditional and Roth IRAs:

***Traditional IRAs*.** Contributions to a traditional IRA may be wholly or partially tax-deductible. But deductions are phased out if these two conditions are met:

1. Your modified adjusted gross income (MAGI) exceeds a specified level, *and*
2. You (or your spouse if you're married) are an active participant in an employer-sponsored retirement plan.

Therefore, depending on your situation, some or all of your traditional IRA may not reflect deductible contributions.

Traditional IRA distributions that are attributable to deductible contributions or growth in the account are taxable at ordinary income rates.

***Roth IRAs*.** Contributions to a Roth are never tax-deductible, regardless of your MAGI (though your ability to contribute in a given year may be phased out if your MAGI exceeds certain limits).

Qualified distributions from a Roth IRA that's been in existence for at least five years are 100% tax-free. For this purpose, qualified distributions include withdrawals:

- Made after age 59½,
- Made on account of death or disability, or
- Used to pay qualified first-time homebuyer expenses (up to a lifetime limit of $10,000).

Nonqualified Roth IRA distributions are taxed at ordinary income rates under special "ordering rules." When you take a distribution, contributions are treated as coming out first, so this part is exempt from tax because the contributions weren't deductible. This treatment is followed by conversion and rollover amounts and, finally, earnings. These ordering rules reduce any potential tax liability during the first five years of the account's existence.

In other words, when you convert assets in a traditional IRA to a Roth, you're usually doing it for the lure of tax-free payouts in the future. But a conversion isn't a slam-dunk by any means.

Factors to consider

Under prior law, you had until October 15 of the same year to reverse (or "recharacterize") an ill-fated conversion. For example, a reversal might have been advised if you converted the account and then asset values subsequently declined. However, under the Tax Cuts and Jobs Act, for 2018 and beyond, you can no longer recharacterize a Roth IRA back into a traditional IRA.

So, it's important to think through the details *before* you convert to a Roth IRA. Some of the questions to ask when deciding whether (and when) to make a conversion include:

How much tax will you owe? When you convert to a Roth IRA, you must pay tax on the funds transferred, just like a traditional IRA distribution. You might not want to convert if your account balance is high and you expect asset values to drop. Conversely, a declining value might encourage a conversion.

Do you have money to pay the conversion tax bill? If you don't have enough cash on hand to cover the taxes owed on the conversion, you may have to dip into your retirement funds. For example, you might arrange to pay the tax out of the funds being converted. This will erode your nest egg, however. The more money you convert and the higher your tax bracket, the bigger the tax hit.

What's your retirement horizon? Your stage of life can affect your decision. Typically, you wouldn't convert a traditional IRA to a Roth IRA if you expect to soon retire and start drawing down on the account right away. Usually, the goal is to allow the funds to grow and compound over time without any tax erosion.

How do you expect your tax rate to change in retirement? If you anticipate being in a *lower* tax bracket when you retire than you're in now, you may not want to convert — it might be easier to absorb tax on future distributions than it is to pay a conversion tax this year. On the other hand, if you expect to be in a *higher* tax bracket in retirement than you're in now, a conversion now often makes sense, absent any other extenuating circumstances. To complicate matters, Congress could change tax rates in the future.

Will you have other sources of retirement income, besides your IRAs? If most of your retirement funds are invested in assets that would trigger taxes on distribution — such as growth stocks or a 401(k) plan — a Roth conversion may provide some flexibility later in life. It can help meet your lifestyle or estate planning objectives without triggering tax on every withdrawal. Because you can't predict how the tax laws will change over time, it's a good idea to build some tax diversification into your accounts.

Another important factor to consider is required minimum distributions (RMDs). While RMDs have been waived for 2020 due to the COVID-19 pandemic, normally with a traditional IRA, you must begin taking RMDs by April 1 of the year after the year you turn age 72. (This age was raised from age 70½ by the SECURE Act, effective for taxpayers who didn't turn age 70½ before January 1, 2020 – that is, who were born after June 30, 1949.) For each subsequent tax year, an RMD must be made by December 31 of that year.

However, there are no mandatory lifetime distributions with a Roth IRA. This can help preserve wealth for your heirs.

A common misconception

Converting a traditional IRA to a Roth IRA isn't an all-or-nothing deal. You can convert as much or as little of the money from your traditional IRA account as you like. So, you might decide to gradually convert your account to spread out the tax hit over several years.

A gradual conversion strategy can allow you to pay the conversion tax from money currently at your disposal instead of tapping into your retirement funds. As a result, your nest egg won't be diluted by the amount you have to subtract to pay the tax.

Furthermore, if you convert a traditional IRA in stages, you may pay less tax overall because more of the transferred amount will be taxed at lower rates under the federal graduated income tax rate system.

What's right for you?

Always contact your tax advisor before converting a traditional IRA to a Roth IRA. He or she can discuss the pros and cons, along with providing other retirement planning recommendations.

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