TRANSCRIPT: Revisiting Roth Conversions: A Conversation with Tony Kure, CFP®, Director of Northeastern Ohio Market and Portfolio Manager, and Scott Wyckoff, CFA, CFP®, Senior Portfolio Manager, Principal

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Scott Wyckoff: Hello, welcome to another audio update from Johnson Investment Counsel. My name is Scott Wyckoff and I'm a Portfolio Manager in our Wealth Management division, and today I'm speaking with Tony Kure. Tony's a Certified Financial Planner and is a Portfolio Manager and the Director of Wealth Management in our Northeastern Ohio Market. Today Tony and I are going to be discussing the ins and outs of Roth Conversions, which have generated a lot of conversation this year in light of recent events. So, Tony, let's just jump right in. Let's start with the basics. Talk about IRA's Roth IRA's and what a conversion is.

Tony Kure: Sure. So for the baseline understanding of a conversion, you have to know the difference between a Roth and a traditional IRA. In the most fundamental terms a traditional IRA is a retirement savings vehicle where money is put in by the saver and the money that is put into this account is not taxed as part of your income that year. That money then grows tax free until it's time to retire and you take the money out and you pay taxes at that time - retirement. The opposite of that or the inverse of that is the Roth IRA, where you're not getting a tax deduction while you're saving to this account, but it grows tax free as well. When the money is taken out in retirement, you do not have to pay taxes on it. So there are some advantages of having those two different types of accounts. The conversion is nothing more than voluntarily moving assets or moving dollars from a traditional IRA and paying the tax on it, the year that you do that, into the Roth IRA - to that asset or account type - that is then going to grow tax free.

Scott Wyckoff: OK, so traditional thought always said defer taxes whenever possible. So this concept accelerates taxes. So talk us through - what are the reasons you would want to do this?

Tony Kure: The logic behind the voluntary conversion or the voluntary incurring of tax liability by doing a Roth conversion is really the fancy term - a tax arbitrage strategy. All that means is we're going to make the educated guess that the rate we're paying on the dollars that we convert from a traditional IRA to a Roth this year, for example, is going to be lower than the rate we think we're going to pay in retirement on those same dollars. So basically making the bet that tax rates today are going to be lower than what we're going to be paying on and when we take those dollars out in retirement.

Scott Wyckoff: OK. And then there's another piece to it in terms of if I'm an heir of IRA assets, I would much rather inherit those Roth IRA assets, correct?

Tony Kure: Yes. And there are some legislation changes that we'll talk about in a little bit. But that's the other piece of it, too, if your heirs inherit a Roth IRA. In the past, if they inherited a traditional IRA, when they took the money out, they would be taxed at their rate. With a Roth IRA, you still have to take distributions, there's just no tax consequences when you do have to take the money out with an inherited Roth IRA.

Scott Wyckoff: Great. So none of this is new. Roth's have been around for a while now, so why is there more conversation about it in 2020? There's obviously a lot going on in the world. So can you talk about why this has led to more Roth conversion conversations?

Tony Kure: Well, yes, 2020 has been certainly a tumultuous year, and we think there's some events that have occurred from a market perspective and from a government legislation perspective and even from an economic perspective that really are causing us to do a timely revisit of Roth conversions for a lot of our clients. Let's start with the near term - markets have rebounded somewhat, but are still down. Over the long term we think that the stock market or equities appreciate in value, using history as our guide, so if we're converting dollars that have the potential to grow from the levels that we're at now. Again, Roth's grow tax free and the tax free distributions can be very attractive to use this as an opportunity to make lemonade out of lemons and to have these dollars grow tax free at what could be low levels, when you compare them to 10 years from now. So that's more of the near-term.

There are a couple pieces of legislation that really are impacting this. First is the CARES Act that was just passed in the end of March to help address the Coronavirus. That suspended required minimum distributions for retirees who otherwise would have to take them this year. Required minimum distributions are taxable income. So for those who no longer have to take that, this could be a lower than normal income year that we might take a look at filling up the tax return in some measure with some taxable dollars at a lower rate in exchange for not having to pay the tax on those dollars in the future when required minimum distributions again will be required. So, again, trying to use this window of opportunity, which could be a low tax rate year for retirees. From an inheritance perspective, there was another law passed at the end of December 2019, called the Secure Act that changed also how heirs inherit IRAs. We talked about it a little earlier, but basically it ended inheritors' ability to stretch out their withdrawals from traditional IRA's over their lifespan. So that would mean that if it's a much younger person, a very small amount could be taken out. Well, that's been compressed to now having to be take this out over 10 years for the maximum, which then would require larger distributions. The problem with that is a high tax rates on large distributions. If we have those accounts in Roth's, again, no tax on those distributions. So the government has changed the rules somewhat, which makes the Roth's more attractive.

And then just from a longer term perspective, the federal government is, as we all know, borrowing excessive amounts of money to try to fill the gap and help address the Coronavirus, could be a four trillion dollar budget deficit. Based on where tax rates are today after the recent tax law changes that have lowered tax rates, we think longer term, they need to rise again to help fill that budget gap, which shouldn't surprise anybody that tax rates could be going up. So taking this all together, we think it's a really attractive window in 2020 to take again, a look at Roth conversions as a wealth planning strategy.

Scott Wyckoff: OK, great. So you've talked about the reasons you might do it, but what are some of the pitfalls to watch out for as people consider this?

Tony Kure: So anytime we're talking about voluntarily incurring income into a tax return, we'd be very conscious of potential collateral damage. This doesn't happen in isolation. In other words, we just don't take these dollars and pay a tax on it. We have to try to figure out what would be the other impacts to other sources of income that can be happening - specifically on capital gains. We may not have to worry about that this year so much. But when you do a Roth conversion and you have gains on other income as capital gains or different rates for that. And those rates are from selling other assets. So that's one we have to be aware of. The other one is Social Security. For taking Social Security, you don't have much income, well, not much of your Social Security is taxed. But if we voluntarily incur the income that increases the amount of your Social Security, that would be subject to tax. And then finally, for retirees who are on Medicare, there are income adjusted penalties, so to speak, for Medicare premiums. If you have higher income, it could raise your Medicare premiums, so we have to look at the rest of the tax return before we're doing this. And really, that's why we advise you to work with a tax planner or a CPA, someone who's very familiar with the tax returns before executing on this, because there could be a lot of other moving pieces that we have to consider.

Scott Wyckoff: Well, that makes sense. Thanks, Tony, so much for all those details and insights. And thanks to everyone for listening. For more of our perspective, you can always visit our website. And as always, feel free to reach out to us at Johnson if you have any questions.