Changes to Income Tax May Make for Favorable Roth IRA Conversions

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The Two Types of IRAs

In order to save for retirement, individuals may choose to contribute to a variety of different types of accounts, one of which is called an Individual Retirement Account ("IRA"). There are two types of IRAs – a traditional IRA and a Roth IRA.

Contributions made to traditional IRAs are "pre-tax" contributions, whereas contributions made to Roth IRAs are "after-tax" contributions. However, unlike traditional IRAs, withdrawals taken from Roth IRAs generally are not subject to income tax because the income tax was previously paid on the funds at the time of the contribution.

Thus, Roth IRAs can be favorable to your descendants at death, because they will not be responsible for paying income tax on the Roth IRA assets (as they would with a traditional IRA), which includes growth in the account.

Roth IRA Conversions

Roth IRAs offer an advantageous planning opportunity to "lock in" the current income tax rate, particularly when there is a high likelihood that the government will raise income taxes in the future. The amount permitted to be contributed to a Roth IRA in any year is capped. However, the law does permit you to convert a traditional IRA to a Roth IRA, and pay the current income tax rates on the portion of funds converted, thereby avoiding the obligation to pay potentially higher income taxes on the funds in the future and avoiding income tax on the growth of the converted assets.

Why Individuals Might Consider a Roth IRA Conversion under the Biden Administration

In addition to the changes to the federal estate tax Exclusion Amount proposed by the Biden Administration, as discussed in the article above, it is also likely under the Biden Administration that the income tax rates will be raised for individuals earning more than $400,000 annually. A proposal from the Biden Administration includes increasing the highest marginal tax rate to 39.6%.

Converting to a Roth IRA may offer an opportunity to capitalize on the current income tax rates before the tax rates are raised in the future. However, a Roth IRA conversion may not be the best option for everyone, particularly because a Roth IRA conversion will cause a large tax bill to be incurred up-front.

Additionally, you or your descendants may be in a lower tax bracket when funds are withdrawn from the IRA – so it may still be better to defer the payment of income tax until assets are withdrawn. To learn more about whether a Roth IRA conversion may be right for your individual situation, you should discuss the option with your financial advisor or contact a trusts and estates attorney at Foster Swift.