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Developing a solid approach to advising clients on Roth IRAs

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Roth IRAs are a popular personal financial planning tool, owing to the various benefits they offer. Building profiles of the "ideal" Roth IRA owner and then using analytical tools to model various scenarios is a practical approach to identifying clients who may benefit from these tax-advantaged retirement accounts.

Before digging into this profiling model, it may be helpful to briefly look at the mechanics and history of the Roth IRA. Created in 1997 and named after Sen. William Roth, R-Del., the Roth IRA expanded retirement planning opportunities and took the popular traditional IRA concept to a new level (Taxpayer Relief Act of 1997, P.L. 105-34). Roth IRAs differ from traditional IRAs in that contributions are nondeductible and they require no minimum distributions, yet qualified distributions are tax-free.

Since the creation of Roth IRAs, taxpayers have been allowed to establish one through direct contributions or by converting a traditional IRA into a Roth IRA. These options were not initially available to all individuals, since eligibility for direct contributions and conversions was limited by a taxpayer's modified adjusted gross income (MAGI). This left many high-income taxpayers ineligible to use this retirement planning tool.

In 2005 (effective for tax years beginning after 2009) the MAGI limitations were repealed but only for traditional IRA conversions to a Roth IRA, commonly referred to as a Roth conversion (Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222). Bearing in mind that a Roth conversion generates taxable income, the opportunity to recharacterize the Roth IRA back to a traditional IRA within a certain period was certainly reassuring to those partaking of this new opportunity. The reset ability proved useful when converted Roth IRA values suddenly dropped during the period in which taxpayers were allowed to undo the transaction.

Now that Roth IRA conversions are accessible to all taxpayers regardless of income level, they have grown in popularity and have become a staple of financial planning. However, investors are witnessing the government's sentiment toward Roth IRAs slowly change with the repeal of the ability to recharacterize the Roth IRA back to the traditional IRA (a change contained in the law known as the Tax Cuts and Jobs Act, P.L. 115-97) and the shortening of the stretch period. This latest change — made in the Setting Every Community Up for Retirement Enhancement (SECURE) Act, P.L. 116-94 — now requires most nonspousal inherited IRAs to distribute the entire account within 10 years. Prior to this change, distributions from an inherited IRA could be stretched over a beneficiary's lifetime. This was a major change to the assumptions under which prior Roth conversion planning was done.

Even with the recent legislative pullbacks, Roth IRAs may still play a meaningful role in clients' retirement planning. As such, finding a strategy for determining their applicability for a client may seem like a daunting task. However, this challenge can be easily met with an adequate analytical modeling tool and a method of identifying suitable clients.

Tools

With the goal of properly demonstrating the pros and cons for Roth conversions, an analytical modeling tool (whether off-the-shelf or custom-made) should provide the following parameters:

- Compare pretax and after-tax values on an annual basis over a client's lifetime. Will the individual monetarily benefit from the conversion during his or her lifetime?
- Compare estate tax impact at death. Will estate taxes diminish any benefits from the conversion?
- Compare pretax and after-tax values on an annual basis during the 10-year stretch period of the inherited IRA or Roth IRA. Will the beneficiary monetarily benefit from the conversion during his or her lifetime?

Without the proverbial "crystal ball," the analysis must factor in assumptions for certain variables. It is important to temper clients' expectations as to the accuracy of these variables, which would include:

- Pretax and after-tax rates of return;
- Income tax rates; and
- Estate tax rates.

Having a model that can reflect these parameters, coupled with a good understanding of how each variable can affect the results, will help advisers and clients make informed decisions regarding Roth conversions. It may be helpful to have an in-depth discussion regarding all assumptions with the client. As has been seen, legislative changes can quickly alter the assumptions that drive the analysis on which clients are depending to make their decisions.

Identifying clients

As previously mentioned, it can be helpful to identify broad client groups whom Roth IRAs may benefit by searching for certain defining characteristics, with a focus on Roth conversions. From this point, a tax adviser can zero in on specific clients. These characteristics can include parameters such as net worth, position in the client's lifecycle, legacy goals, or other characteristics. Below are a couple of profiles of ideal clients who may benefit from a Roth IRA conversion or a Roth IRA contribution.

Individuals who will not need to use the IRA within their own lifetime

Individuals who will not need to use the IRA within their own lifetime would have the following characteristics:

- Not intending to use the IRA for charity;
- Not intending to use the IRA to support lifestyle needs; and/or

- Having sufficient non-IRA funds to pay the income tax on conversion.

Compare pretax and after-tax values on an annual basis during the 10-year stretch period of the inherited IRA or Roth IRA.Will the beneficiary have greater value from a conversion?

Individuals who will draw from the account to support lifestyle needs

Individuals who will draw down the account to support their lifestyle would have the following characteristics:

- Not intending to use the IRA for charity;
- Intending to use the IRA to support lifestyle needs;
- May or may not have sufficient non-IRA funds to pay the income tax on conversion; and/or
- Intending to leave the remaining IRA to heirs.

Compare pretax and after-tax values on an annual basis over the client's lifetime. Will the individual receive greater value from the conversion during his or her lifetime?

Pulling it all together

Once you have a working model and identify client groups, develop a presentation style that allows clients to focus on the aspects that are most relevant to their needs. While a consideration of how the Roth IRA may benefit a client's beneficiaries may be important, you may not want to accentuate this factor for a client who is primarily concerned about meeting his or her own lifestyle needs during retirement. Instead, you would want to demonstrate the lifetime benefits along with the potential risks. This is one example of the various considerations to be assessed on a client-by-client basis.

Setting expectations

Regardless of whether you use a back-of-the-envelope calculation or a sophisticated model, clients will likely act on your advice. Set appropriate expectations for clients by reminding them that actual results are subject to change, which may come in the form of unexpected pullbacks on certain beneficial attributes or unexpected market performance. For example, consider individuals who completed a Roth conversion in 2010 expecting beneficiaries to be drawing on the account for 30 years or more after their death (now limited to a 10-year withdrawal period by 2019's SECURE Act). Hopefully, their advisers cautioned them about potential future legislative changes.

Not an all-or-nothing proposition

While large Roth conversions garner much of planners' attention in this area, it is important to consider other avenues to a Roth IRA.

Piecemeal Roth conversions

A client can create Roth IRAs through piecemeal conversions and take advantage of lower tax brackets throughout the process. This can make the overall cost of the conversion significantly lower than would be the case with a one-time full conversion.

Roth IRA contribution for dependent children with wages

Clients with wage-earning young children or grandchildren can create Roth IRA accounts for them gift tax-free by using the annual gift tax exclusion ($15,000 per donee for 2020). If a client is currently making annual gifts to children or grandchildren, it may be beneficial for him or her to fund a Roth IRA to the maximum allowable amount. This would surely be the gift that keeps on giving.

Individual's employer 401(k) accepts rollovers

Working clients with rollover IRAs in place from a prior employer's 401(k) plan can consider rolling the rollover IRA into their current employer's 401(k), if eligible. Doing so may allow them to make current-year nondeductible traditional IRA contributions and then convert to a Roth IRA with little or no income tax. This is typically referred to as a "backdoor" Roth conversion.

Qualified plans allowing rollovers to Roth IRAs

Working clients who participate in their company's retirement plan, such as a 401(k) plan, should inquire if the plan allows annual after-tax contributions above the normal maximum deductible amount, subject to the annual defined contribution plan limit. If so, the client can effectively make a tax-free Roth IRA conversion of his or her after-tax contributions upon separation from service (Notice 2014-54).

Nondeductible IRA contributions

For clients planning to convert to a Roth IRA, or who already have a Roth IRA but are unable to contribute directly, nondeductible contributions to a traditional IRA can be useful. As there are annual IRA limits, making nondeductible contributions can help maximize a client's overall retirement asset balance and provide an opportunity to make Roth IRA conversions in a tax-efficient way, as shown in the discussion above, under "Individual's Employer 401(k) Accepts Rollovers."

Stock market declines and tax rate increases or decreases

Economic and legislative events may provide opportunities for Roth IRA conversions. Stock market declines make Roth IRA conversions cheaper, as there is less tax to pay. However, the actual savings depend on whether the funds that will be used to cover the tax have also declined in value. When tax rates are set to increase, clients may feel that it is a now-or-never proposition and will convert their traditional IRAs at the lower tax rate. The same impulse may arise when tax rates drop.

A well-grounded starting point

While Roth IRAs have not always been available to all taxpayers, legislative changes within the last decade or so have expanded eligibility to more taxpayers, in addition to driving their popularity. Identifying exactly which clients may benefit from a conversion can be a challenge.

A practical approach to identify these clients can be to create profiles of ideal clients who would benefit from a Roth IRA conversion and matching actual clients to those profiles based on common characteristics. From this point, the conversion should be modeled and reviewed analytically, using various assumptions. It is important to temper client expectations as to how volatility of assumptions can drive the analytical model and, ultimately, the client's decisions. These assumptions include items such as market performance and potential legislative changes.

As they aim to help clients make informed decisions, advisers are responsible for providing solid analytics and well-thought-out discussions, highlighting the pros and cons of all decisions. Having a solid approach in place is a good starting point.

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