LORD ABBETT

RETIREMENT PERSPECTIVES

Market Volatility: Time to Consider a Roth Conversion

March 27, 2020

Brian Dobbis, QKA, QPA, QPFC, TGPC
Director, Retirement Solutions

When markets are down, it's a good opportunity to think about converting a traditional IRA to a Roth.

The recent **market volatility** has created one bright spot: we believe this is a good opportunity for retirement investors to consider a Roth conversion. Why? Because the reduced value of portfolios caused by a market decline could result in less taxation on a portfolio. Although it may not seem like it, converting a traditional IRA to a Roth IRA today could have an impactful long-term upside for both you and your heirs, in our view.

When you convert to a Roth account, traditional IRA pretax dollars (including a SEP or SIMPLE IRA) will then be subject to taxation to be included in your income in the year of the conversion. For example, converting a $100,000 traditional IRA to a Roth IRA anytime in 2020 will increase taxable income by $100,000. The additional income will be included on your 2020 tax return (filed in 2021) and is subject to both federal and state (if applicable) taxes.

Taxes resulting from conversion are based on the account's fair market value at the time of the conversion. Therefore, if you convert now when your account value is lower, you are well positioned to take advantage of potential tax free distributions later, when the market recovers.

For example, Ted converts his IRA valued at $50,000 to a Roth IRA. Ted will have an additional $50,000 of income; however, any growth in his account will be distributed tax free as long as it's a *qualified* Roth distribution.

Tip! Individuals under age 59½ who make a Roth conversion are not subject to the 10% early withdrawal penalty tax that would normally apply to a pre-age 59½ distribution.

Other potential benefits of a Roth

Besides volatile markets, there are other reasons to convert to a Roth IRA. First, the Tax Cuts and Jobs Act of 2017 lowered tax rates for many taxpayers. However, these low rates are not permanent; the rates expire on December 31, 2025, and it's expected that we will revert to pre-2018 tax rates, which for most taxpayers are higher than today's rates. Unfortunately, no one can predict where taxes are going in the future. But with trillion dollar deficits, it's likely that taxes will increase potentially significantly. A Roth conversion is a method to hedge against higher taxes in the future. Converting now locks in today's low rates. This presents a small but tremendous window of opportunity to pay less tax on a smaller asset base.

2020 Income Tax brackets

Taxable Income

Rate	Unmarried	Married	Heads of Households
10%	0 - $9,875	0 - $19,750	0 - $14,100
12%	$9,876 - $40,125	$19,751 - $80,250	$14,101 - $53,700
22%	$40,126 - $85,525	$80,251 - $171,050	$53,701 - $85,500
24%	$85,526 - $163,300	$171,051 - $326,600	$85,501 - $163,300
32%	$163,301 - $207,350	$326,601 - $414,700	$163,301 - $207,350
35%	$207,351 - $518,400	$414,701 - $622,050	$207,351 - $518,400
37%	$518,401+	$622,051+	$518,400+

Married filing separately pay at same rate as unmarried. Source IRS

Another potential benefit is Roth IRAs are not subject to required minimum distributions (RMDs) for both the owner and surviving spouse beneficiary. Notably, designated Roth 401(k) accounts are subject to lifetime RMDs. In addition, bequeathing a Roth account to a family member offers the potential of a tax free inheritance.

Qualified Roth IRA distributions are tax-free and penalty-free. A Roth IRA distribution is deemed qualified if the account satisfies the **five-year rule** and funds are withdrawn:

On or after turning age 59½

Permanent disability

Made by a beneficiary (after your death)

Used to buy, build, or rebuild a first home ($10,000-lifetime limit).

Non-qualified Roth IRA distributions are those distributions that **don't** meet the guidelines for qualified distributions. Here you'll be subject to income tax rate on earnings plus an additional 10% penalty unless you satisfy an exception.

What are the downsides of a Roth conversion?
First, as mentioned earlier, you are subject to income tax in the year of conversion. Therefore, you need to determine if you have money to cover the tax liability. In addition, the additional income (due to the conversion) could "bump" you to higher tax bracket (federal and or state). Furthermore, the additional taxable income could result in phase-out of tax deductions and tax credits, reduced student aid, and be subject to 3.8% net investment income surtax.

For retirees considering converting, there are additional variables including: potentially subjecting your Social Security benefits to taxation, increased Medicare Part B and Part D premiums, and an increased threshold for the medical expense deduction.

Tip! All individuals regardless of age and/or income are eligible to convert to a Roth IRA. However, you can't convert an RMD for a given year. Therefore, if you are subject to an RMD, you must take the RMD first. For example, Tony, age 80, wants to convert $10,000 to his Roth IRA but he also owes a $4,000 RMD. He must take the $4,000 RMD prior to making a Roth conversion. The ***SECURE Act increased the age for starting RMDs to age 72*** *for most retirement account holders.*

What else do I need to know?

- Making a Roth conversion increases taxable income in the year of conversion, but it can lower taxable income in subsequent years.
- For conversion purposes, all of your IRAs (including SEP and SIMPLE) are treated as one *single* IRA account. Because all of your IRAs are treated as one account, you generally ***cannot*** segregate basis (i.e. after-tax contributions). Therefore, any conversion done from any IRA account will be deemed to consist of some pretax funds and some aftertax funds. This is commonly referred to as the *pro-rata* distribution rule.
- Partial conversions are permitted. You can convert as little or as much money as you feel comfortable.
- You may convert pretax 401(k) assets to a designated Roth 401(k) (as opposed to a Roth IRA) account via an in-plan Roth conversion. However, you plan must specifically allow for this provision.
- Prior year Roth *contributions* can be made up to your tax filing deadline (not including extensions). However, to have a 2019 Roth IRA conversion, the funds must be distributed from the traditional IRA by year-end. A conversion done in 2020 will be reflected on your 2020 tax return.
- As part of the Tax Cut and Jobs Act, recharacterization of Roth *conversions* from traditional IRAs and qualified plans (e.g., 401(k)) was repealed. As a result, *all* Roth conversions taking place on or after January 1, 2018 are permanent. However, there is a workaround – although buyer beware – it's risky. Using this advanced strategy, instead of converting (directly from a traditional IRA-to-Roth account; the owner would use the once-per year (365 day) 60-day rollover option to simulate recharacterization.
- Roth conversion dollar cost averaging – This often-overlooked strategy consists of converting smaller amounts throughout the year instead of doing a single large conversion. For example, instead of making one single large $80,000 Roth conversion today, you can make four separate conversions of $20,000 per quarter.
- A Roth conversion is not one-size-fits-all – it is a complex transaction. Discuss whether a conversion makes sense with your financial and tax professionals

Advisors, if you have additional questions, please contact your Lord Abbett representative at 888-522-2388.

To comply with Treasury Department regulations, we inform you that, unless otherwise expressly indicated, any tax information contained herein is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties that may be imposed under the Internal Revenue Code or any other applicable tax law, or (ii) promoting, marketing, or recommending to another party any transaction, arrangement, or other matter.

The information is being provided for general educational purposes only and is not intended to provide legal or tax advice. You should consult your own legal or tax advisor for guidance on regulatory compliance matters. Any examples provided are for informational purposes only and are not intended to be reflective of actual results and are not indicative of any particular client situation.

The information provided is not directed at any investor or category of investors and is provided solely as general information about Lord Abbett's products and services and to otherwise provide general investment education. None of the information provided should be regarded as a suggestion to engage in or refrain from any investment-related course of action as neither Lord Abbett nor its affiliates are undertaking to provide impartial investment advice, act as an impartial adviser, or give advice in a fiduciary capacity. If you are an individual retirement investor, contact your financial advisor or other fiduciary about whether any given investment idea, strategy, product or service may be appropriate for your circumstances.

GLOSSARY OF TERMS

Traditional IRA contributions plus earnings, interest, dividends, and capital gains may compound tax-deferred until you withdraw them as retirement income. Amounts withdrawn from traditional IRA plans are generally included as taxable income in the year received and may be subject to 10% federal tax penalties if withdrawn prior to age 59½, unless an exception applies.

A **Roth IRA** is a tax-deferred and potentially tax-free savings plan available to all working individuals and their spouses who meet the IRS income requirements. Distributions, including accumulated earnings, may be made tax-free if the account has been held at least five years and the individual is at least 59½, or if any of the IRS exceptions apply. Contributions to a Roth IRA are not tax deductible, but withdrawals during retirement are generally tax-free.

A **SIMPLE IRA** plan is an IRA-based plan that gives small-business employers a simplified method to make contributions toward their employees’ retirement and their own retirement. Under a SIMPLE IRA plan, employees may choose to make salary reduction contributions and the employer makes matching or nonelective contributions. All contributions are made directly to an individual retirement account (IRA) set up for each employee (a SIMPLE IRA). SIMPLE IRA plans are maintained on a calendar-year basis.

A **simplified employee pension plan (SEP IRA)** is a retirement plan specifically designed for self-employed people and small-business owners. When establishing a SEP IRA plan for your business, you and any eligible employees establish your own separate SEP IRA; employer contributions are then made into each eligible employee’s SEP IRA.

A **required minimum distribution (RMD)** is the minimum amount an account owner must withdraw from a retirement account each year. An owner generally has to start taking withdrawals from a retirement plan account at age 70½. Roth IRAs do not require withdrawals until after the death of the owner.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Lord Abbett Funds. This and other important information is contained in the fund's summary prospectus and/or prospectus. To obtain a prospectus or summary prospectus on any Lord Abbett mutual fund, you can click here or contact your investment professional or Lord Abbett

Distributor LLC at 888-522-2388. Read the prospectus carefully before you invest or send money.

The information provided is not directed at any investor or category of investors and is provided solely as general information about Lord Abbett's products and services and to otherwise provide general investment education. None of the information provided should be regarded as a suggestion to engage in or refrain from any investment-related course of action as neither Lord Abbett nor its affiliates are undertaking to provide impartial investment advice, act as an impartial adviser, or give advice in a fiduciary capacity. If you are an individual retirement investor, contact your financial advisor or other fiduciary about whether any given investment idea, strategy, product or service may be appropriate for your circumstances.