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PERSONAL FINANCE

Biden Tax Plan's Potential Impact on Your IRA

For people with traditional retirement accounts, Roth conversions may gain traction this year



President Biden, addressing Congress on Wednesday, has proposed raising the top tax rate as part of the American Families Plan.

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Tax rates seem likely to rise for the wealthiest and highest-earning taxpayers under the Biden administration. For those with traditional retirement accounts, making moves ahead of tax law changes can reduce income-tax bills in retirement.

The key strategy to pursue is the Roth conversion. These allow account owners to transfer some or all of the money in a tax-deferred IRA or 401(k) to a Roth account, in which you contribute after-tax dollars and get tax-free withdrawals. For workers with the option, it can also make sense to funnel future retirement account contributions into a Roth 401(k).

“If there ever was a year to do it, this would be the year to maximize Roth conversions,” said Jamie Lima, a financial planner in San Diego.

Although you will have to pay income tax on the transfer, thanks to the tax cuts enacted in 2017, many high earners stand to pay a lower tax rate today than they would by deferring the payments until retirement, says Ed Slott, an IRA specialist in Rockville Centre, N.Y.

“Tax rates today may be the lowest you will see for the rest of your life,” he said. For people with big retirement account balances, it can make sense “to pay tax today to lock in current rates and eliminate the risk of higher rates in the future.”

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What changes around saving for retirement are you considering in light of the new tax plan? Join the conversation below.

Under the Biden proposal introduced Wednesday, the administration would raise the top income-tax rate to 39.6% from 37%. Currently, that applies to taxable income above \$523,600 for individuals and \$628,300 for married couples.

It would also raise the top rate on capital gains from today's 23.8% to 43.4%, including a 3.8% tax on investment income, for households making more than \$1 million.

With a traditional IRA or 401(k), individuals generally get to subtract contributions from their income and reduce the taxes they pay. Amounts in the account grow tax-free, but owners must pay ordinary income tax on the money when they withdraw it in retirement.

Why bother converting? Once you hold a Roth for at least five years and are age 59½ or older, future withdrawals of both principal and appreciation are tax- and penalty-free.

In retirement, people with Roth accounts can take tax-free withdrawals to supplement their taxable income and stay within a lower tax bracket. Some may be able to use Roth withdrawals to reduce or avoid the surcharges on Medicare premiums that kick in above \$88,000 in income for individuals and \$176,000 for couples.

Another advantage to a Roth is you won't ever have to take a required distribution.

Those who seem most likely to benefit from converting money to escape future tax increases are people with incomes of more than \$400,000, said Jeffrey Levine, chief planning officer at Buckingham Wealth Partners. The reason: During the 2020 campaign,

President Biden proposed higher payroll taxes on those taxpayers, although the administration has yet to attach that provision to a particular plan.

For Roth conversions to make sense, “you’ve got to believe you will be in a higher tax bracket in retirement,” Mr. Levine said.

To maximize the “dollars that can grow tax-free in the future,” the account owner should ideally pay the tax using money outside the IRA, he said.

Given the proposed increase in the capital-gains tax rate, Mr. Levine said, it may make sense to sell stocks held in brokerage accounts to lock in today’s lower capital-gains tax rate and use the proceeds to pay the Roth conversion tax bill.

For those still contributing to retirement savings accounts, another way to amass Roth assets is to switch contributions from a traditional 401(k) or IRA to a Roth account. Almost three-quarters of employers who use Vanguard Group Inc. as a 401(k) administrator offer Roth 401(k)s. Anyone can contribute to one, regardless of income.

In contrast, individuals who earn \$140,000 or more and couples with incomes above \$208,000 cannot contribute to a Roth IRA. But there is a way around this rule.

The key is to put money you already paid taxes on into a traditional IRA and convert it to a Roth IRA. Because you already paid income tax on the contribution, you will owe tax only on the appreciation your investments have earned when you do the Roth conversion. If you convert quickly, your investments won’t have much time to appreciate, Mr. Slott said.

If you have other IRAs, this is likely to become more complicated. That is because tax rules prevent those with traditional IRAs that contain both pretax and after-tax money from converting only the after-tax money.

Say you have \$50,000 in a pretax IRA. If you put \$7,000 of after-tax money into a separate IRA, you can’t convert only the \$7,000. Instead, you must divide your after-tax contributions of \$7,000 by the total balance in both of your IRAs of \$57,000. The result—12.3%—is the percentage of the conversion the Internal Revenue Service considers tax-free—or \$860 of a \$7,000 conversion.

You can avoid this problem if you roll all of your pretax IRA money into your current employer’s 401(k) plan, if the plan allows this. Because you can’t roll after-tax money into

a 401(k), the \$7,000 in nondeductible contributions will remain behind in your IRA, where it can be converted tax-free to a Roth IRA.

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