Consider Roth Conversions in a Down Market

RETIREMENT PLANS

When an IRA owner or Qualified Plan participant executes a Roth Conversion by moving assets from a traditional, SEP, or SIMPLE IRA, as well as a pre-tax Qualified Plan to a Roth IRA or Roth Qualified Plan, he or she is paying ordinary income tax on any pre-tax assets being converted. By converting assets while the account is lower in value, the individual is paying taxes on a smaller investment portfolio and thus paying less taxes overall. Compare this to leaving the assets in a pre-tax IRA or Qualified Plan where Required Minimum Distributions (RMDs) at age 73 may force the individual to pay taxes when the account value is higher and potentially at higher tax rates (after the Tax Cuts & Jobs Act of 2017 expires).

Since Roth Conversions can be done in-kind, the idea is to convert depreciated securities while tax rates are lower to reap the benefits of tax-free Roth money if tax rates increase and/or the securities appreciate in the future. Once the Roth IRA has met five years and age 59½, all assets are withdrawn tax-free and penalty-free, making the Roth IRA a crucial source of tax-free income in retirement. Think of all of the potential tax-free Roth earnings if the depreciated securities go up in value in the future. While an in-kind Roth Conversion may be more appealing during a market downturn, here are some other important considerations for individuals contemplating a Roth Conversion:

1. **Age** – The younger you are, the longer time horizon you have until retirement to optimize tax-free compounding in a Roth IRA.
2. **Current Tax Rates Versus Future Tax Rates** – While it is impossible to predict future tax rates, if you are more likely to be in a higher tax bracket (or have a higher tax rate) in the future versus now, a Roth Conversion becomes more advantageous.
3. **Tax Diversification** – If you have a majority of your retirement assets in pre-tax accounts, converting some of those assets to a Roth allows for flexibility during retirement years to draw from certain accounts to keep yourself in a favorable tax bracket.
4. **Offsetting Net Losses** – For business owners, in years where you have net operating losses, you can utilize Roth Conversions in a potentially tax-free manner, as net operating losses can offset ordinary income.
5. **Paying the Taxes Due** – As an individual, you have the option to pay taxes on a Roth Conversion by withholding from the IRA or Qualified Plan upon conversion or pay the taxes from a retail account by tax filing deadline; however, if you are under age 59½, the IRA or Qualified Plan withholding may be hit with ordinary income tax and a 10% early withdrawal penalty. In addition, Roth Conversions may force you to pay quarterly estimated taxes depending on the size of the conversion and your tax situation.
6. **The SECURE Act's 10-Year Rule/Estate Planning** – If you have very large pre-tax IRAs or Qualified Plans or with beneficiaries in high tax brackets, it may behoove you to do Roth Conversions, so beneficiaries inherit after-tax Roth money. Most non-spouse beneficiaries must have the inherited IRA fully distributed in 10 years (if death occurred in 2020 or after), so if those beneficiaries were to inherit pre-tax assets, that may force the beneficiary to have sizable tax bills at high tax rates due to the 10-year payout rather than stretching the inherited IRA over their life expectancy (if death occurred in 2019 or before; pre-SECURE Act).

There is no minimum or maximum dollar limit on Roth Conversions, no earned income requirement, and no Modified Adjusted Gross Income (MAGI) eligibility restriction in any given year, so virtually anyone with an IRA may convert. However, once assets are converted, it is irrevocable and the conversion cannot be recharacterized (reversed). For this reason, it is imperative for you to discuss Roth Conversion intentions with a CPA or qualified tax preparer before executing the strategy to see how the additional income from a Roth Conversion impacts your tax situation.

Even in a down market, investors can still be proactive with their retirement assets and implement strategies to reduce taxation in the future. Discuss with your Stifel Financial Advisor whether a Roth Conversion is right for you.

Stifel does not provide legal or tax advice. You should discuss your particular situation with your legal and tax advisors.

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