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Roth conversions during market volatility

Explore the benefits of taking Roth conversions during a market downturn.

A down market may provide the opportunity to maximize the amount converted from a traditional pretax IRA to a Roth IRA while engaging in tactical tax planning.

AN OVERVIEW OF ROTH CONVERSIONS

A Roth conversion moves all or part of your traditional pretax IRA to a Roth IRA. Roth conversions are used as a tax planning strategy: accelerating income taxes due on the converted amount to create tax-free retirement account growth.* Generally, amounts converted will be subject to ordinary income tax in the year converted. If your traditional IRA has after-tax contributions, any distributions, including distributions as a result of a Roth conversion, will be subject to the pro rata rule. If after tax dollars are converted to a Roth, there is no tax liability on those dollars.

WHY CONSIDER A ROTH CONVERSION?

- Individuals may convert because they believe their tax bracket will be lower today than in the future.
- Current or expected taxable income in the current year is lower than future years.
- Pay taxes now so that beneficiaries can inherit from the Roth IRA tax free, if certain qualifications are met.
- The SECURE Act limited "stretch" provisions. Most non-spousal beneficiaries will have to take distributions of traditional IRAs over 10 years, recognizing more taxable income in a shorter period of time, which could in turn lead to higher taxes. A Roth IRA must still be distributed within 10 years. However, since qualified distributions from a Roth account are tax free, your beneficiaries can let the Roth account grow and then take the entire distribution in year 10 with no tax consequences.
- A Roth conversion is a planning opportunity to create tax-free income for beneficiaries. It may also be used if the beneficiary is, or plans to be, in a higher tax bracket than the IRA owner or when the account is distributed.
- Create tax diversification in retirement. Roth IRA distributions are generally tax-free, whereas traditional IRA distributions are taxable.
- Having some of each (taxable and tax-free) accounts allows retirees to adjust to future tax environments.
- Limit future required minimum distributions – RMDs – for tax bracket management. A Roth conversion will result in a smaller traditional IRA, which equates to lower RMDs.
- Roth IRA distributions do not increase modified adjusted gross income for Social Security or Medicare premiums.

CONVERSIONS IN THE CURRENT MARKET

A rapid decline of the equity markets could create opportunity for Roth conversions. Implementing a Roth conversion, while the asset values are depressed, could result in a lower tax bill and any resulting appreciation due to a market rebound will grow in the tax-free* Roth IRA. Roth conversions may be done "in-kind," allowing you to fully participate in any market recovery.

When implementing a Roth conversion, consider paying taxes from an outside source, allowing all of the converted funds to grow as opposed to taking a withdrawal from the plan to pay taxes. Keep in mind, distributions from an IRA when the participant is under 59 1/2 may be subject to a 10% penalty.

POTENTIAL CONSIDERATIONS OF A ROTH CONVERSION

Implementing a Roth conversion means paying taxes now, which may not be beneficial if you are in a higher tax bracket today than you expect you will be in the future.

While there are many benefits of Roth conversions, they will increase your taxable income in the year of conversion. Aside from higher taxes, it may also affect other tax deductions, credits, and related items such as Medicare Premium surcharges.

A Roth conversion also isn't beneficial if you need the distributions for immediate expenses.

Also, consider your beneficiaries. If you intend to leave your traditional IRA to a charity, it may not make sense to pay additional taxes today for money that the charity wouldn't be taxed on upon receipt.

The decision to convert a Roth IRA and pay taxes now can be guided by multiple factors. You should consider it if you are in a low tax rate now but will be in a higher tax rate in the future. A Roth is also more advantageous if tax rates go up in the future. Other considerations could include tax diversified retirement savings as well as a tax free gift to beneficiaries.

*In order for earnings to be tax free, converted funds must be held in the Roth IRA for five years and distributions must occur after age 59 1/2 or as a result of death, disability or first time home purchase of $10,000.

WHAT ARE RMDs?

You cannot keep funds in a traditional IRA indefinitely. Individuals are required to withdraw amounts known as required minimum distributions after age 70 1/2, 72, or 73 depending on your year of birth. Roth IRA owners are not subject to RMDs, however, Roth IRA beneficiaries are subject to distribution rules.

WHAT ARE THE STRETCH PROVISIONS?

The 2019 SECURE Act limited the amount of time most non-spousal beneficiaries can "stretch" withdrawals from inherited IRAs. Previously, many beneficiaries could receive distributions over their life expectancy whereas under the SECURE Act, most non-spousal beneficiaries must liquidate the account 10 years. Those who are able to stretch distributions over their lifetime are limited. Please speak with your financial advisor for more information.

Source: Fidelity Investments

Contact your advisor to discuss whether a Roth IRA conversion is suitable for you.

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