The Recent Stock Market Downturn May Provide an Opportunity to Enhance the Benefits of a Roth Conversion

A Roth is a vehicle that is comparable to a traditional IRA or retirement plan in that earnings grow tax-free. The two differ in several significant ways, however. Only taxpayers who meet certain requirements with respect to adjusted gross income may contribute to a Roth IRA. Whereas distributions from a traditional retirement vehicle are subject to income tax to the extent of pre-tax contributions and earnings, distributions from a Roth are entirely tax free so long as certain requirements are met with respect to age (generally 59 ½) and holding periods (generally 5 years). In addition, traditional IRAs, and qualified retirement plans (Roth or otherwise), are subject to the required minimum distribution (RMD) rules at age 72, while Roth IRAs are not.

While the government limits the amount taxpayers may *contribute* annually to a Roth IRA, there are no such limitations on the ability to *conver*t a traditional IRA or qualified retirement plan to a Roth equivalent. A Roth conversion allows any taxpayer to transfer any or all of the funds in an existing traditional IRA or qualified plan to a new or existing Roth account. Upon a conversion, the taxpayer must generally report as ordinary income the pre-tax balances converted. Conversions may take place in cash, but also in-kind, with the latter option allowing the owner to avoid being out of the market while funds transfer.

Despite the immediate income tax consequences of the conversion, Roths are often superior to traditional IRAs and retirement plans for accumulating wealth. As an example, assume Taxpayers A and B are both in the 37% federal tax bracket, each has $100,000 in a traditional IRA, all of it pre-tax, and each has $37,000 in a taxable investment account. Taxpayer A elects to convert the IRA to a Roth and pay the tax due by cashing out the investment account. Taxpayer B does not convert. Upon Taxpayer A's Roth conversion, their situation looks like this:

	Roth IRA	**Traditonal IRA**	**37% Tax Due on Conversion**	**Investment Account**	**Total**
Taxpayer A	$100,000	$0	($37,000)	$37,000	$100,000
Taxpayer B	$0	$100,000	$0	$37,000	$137,000

A and B both expect to earn a gross return of 7.18% per year in their accounts, a return sufficient to double the account balances every 10 years in a world without taxes. Taxpayer B, however, will have to pay tax on the earnings on the investment account. Even if that account were invested entirely in equities, B would still expect to pay a 20% tax on qualified dividends and long term capital gains, and likely the 3.8% Medicare tax. Assuming capital gains are realized periodically as the investment account grows, if both A and B withdraw their IRA balances after 20 years, the results would be as follows.

	Roth IRA	**Traditonal IRA**	**37% Tax Due on Distribution**	**Investment Account**	**Total**
Taxpayer A	$400,000	$0	$0	$0	$400,000
Taxpayer B	$0	$400,000	($148,000)	$107,000	$359,000

Due to the income taxes that B pays on the investment account, the balance grows to only $107,000. This is well short of the amount needed to pay the tax when B withdraws the traditional IRA balance. Taxpayer B, therefore, needs to use $41,000 from the IRA proceeds to pay the remaining income tax due. One could argue that B might be in retirement in 20 years and pay tax at a lower rate. However, B's average tax rate on the withdrawal would have to drop to 26.75% ($107,000/$400,000) before the funds in the investment account would cover the tax.

The two variables that determine the efficacy of the Roth conversion strategy are investment earnings and tax rates. When the stock market is depressed, converting to a Roth at the lower values might permit greater growth inside the tax-free Roth. If we assume that because of opportune timing, gross returns over the next 20 years are 8.5% on average instead of 7.18%, the results look as follows.

	Roth IRA	**Traditonal IRA**	**37% Tax Due on Distribution**	**Investment Account**	**Total**
Taxpayer A	$511,000	$0	$0	$0	$511,000
Taxpayer B	$0	$511,000	($189,000)	$130,000	$452,000

With the greater investment earnings, the breakeven tax rate now drops from 26.75% to 25.44% ($130,000/$511,000). This may argue not only for converting to a Roth when markets are depressed, but also for allocating the more aggressive piece of a taxpayer's investment allocation to the Roth account. (Note that the results would be much different if Taxpayer A elected to pay the tax due at the time of conversion by withdrawing funds from the traditional IRA, rather than the investment account, and convert only the remaining IRA balance. That approach to a conversion is *not* the preferred strategy.)

Who would be a good candidate for a Roth IRA conversion given the current stock market conditions? Taxpayers who expect their tax rate in retirement to be similar to, or higher than, their current rate may wish to examine the benefits of a conversion. Taxpayers who recently retired, have meaningful retirement plan balances, have funds available outside of their retirement plans to pay the tax due on a conversion, and will be in a lower tax bracket until they start taking RMDs at age 72 are particularly good candidates. Indeed, a conversion would likely look better for these candidates than what is shown in our example as, absent a conversion, they could find themselves taking RMDs and paying tax on them before 20 years passed. As there are no RMDs for a Roth IRA while the taxpayer is alive, the earnings remain tax-free for the entire 20 years. (Note that minimum distributions are required from Roth 401(k) and Roth 403(b) plans, suggesting that taxpayers should roll these into a Roth IRA before reaching age 72.)

Please note that effective January 1, 2018, pursuant to the Tax Cuts and Jobs Act, a conversion from a traditional IRA, SEP or SIMPLE to a Roth IRA cannot be recharacterized. The new law also prohibits recharacterizing amounts rolled over to a Roth IRA from other retirement plans, such as 401(k) or 403(b) plans.

Ropes Wealth Advisors LLC
800 Boylston Street Boston, MA 02199-3600