Market Woes Open Door for Roth Conversions

By Steve Garmhausen Financial Planning Magazine

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Looking for silver linings amid the market gloom?

Richard Jackson, principal at advisory firm Schlindwein Associates, in Chicago, says Roth IRA conversions may be it.

“I think there’s a window open right now, especially for folks who have been considering doing a Roth conversion,” he said.

The reason is that doing so may be far cheaper from a tax standpoint than it was just a few weeks ago.

Obviously, converting assets within a traditional IRA into a Roth requires paying taxes on the amount to be converted. Since the market has been hammering assets, including those within traditional IRAs, why not transfer the shrunken asset total into a Roth?

An investor in the 33% tax bracket would owe $33,000 on a $100,000 conversion, Jackson points out. But if the market whacked those assets down to $75,000, the tax burden would fall as well, to $24,750 in this example

“If you’ve got a long time horizon and believe that over time the value of that account will appreciate, it makes some sense in certain situations to take advantage of that now,” he said.

One factor that may tip an investor toward doing the conversion now is the fact that they’ll have at their disposal what Jackson refers to as “a mulligan.”

If an investor does a conversion now and the market proceeds to drop, say, another 25% by spring, he or she will be able to “recharacterize” that account -- essentially putting the money within the Roth back into a traditional IRA. The benefit: The investor gets back the taxes they paid at the time of the original conversion.

At that point, an investor may want to do another Roth conversion, this time paying proportionally less in taxes on the shrunken asset total.

Think of it as rightsizing the tax bill. In fact, those who did conversions last year might want to consider taking a mulligan right about now, Jackson said.

But what are some of the reasons investors might not want to do a conversion right now?

When one converts a traditional IRA to a Roth, it’s considered to be taking income and that might bump an investor into a higher tax bracket. Also, it’s best to have enough cash outside the IRA to pay for taxes -- although Jackson points out that investors can always do partial conversions.

Roth IRAs’ advantages have been well chronicled. Roths allow assets to grow tax-free and be distributed tax-free. They are good estate planning tools as well, since there are no minimum distribution requirements within an owner’s lifetime.