Why Now Could Be a Good Time for a Roth IRA Conversion

Roth IRAs are one of the best gifts that Congress has ever given Americans when it comes to saving money for retirement. Contributions grow tax-deferred like with traditional IRAs, but withdrawals are usually tax-free if they're made after you turn 59½ years-old. Also, there are no Required Minimum Distributions (RMDs) with Roth IRAs at age 70½ like with traditional IRAs. And you can continue making contributions to a Roth IRA throughout your lifetime, regardless of your age, so long as you have earned income.

Congress, however, placed eligibility restrictions based on one's income that prohibit many affluent Americans from using them. In 2019, if your modified adjusted gross income (MAGI) is $122,000 to $137,000 (if you're single) or $193,000 to $203,000 (if you're a married couple filing jointly) in 2019, your contributions are limited.

A Workaround: Roth IRA Conversions

There is one way to enjoy the benefits of a Roth IRA even if you make too much money to contribute to one. You can convert a traditional, SEP or SIMPLE IRA to a Roth IRA.

But there's one big drawback to Roth IRA conversions that keeps many people from doing them: You must pay income taxes on the value of your IRA at the time of the conversion. If your IRA is large, this could result in a big lump sum payment that's due to the IRS when the conversion is made.

Down Market = Conversion Opportunity

If you've been considering a Roth IRA conversion but hesitated because of the big tax bill, now might be a good time to think about pulling the trigger. Why? Because the recent stock market pullback could lessen the severity of the tax bite.

Remember, the amount of income tax due will be based on the value of your IRA when the conversion is made. So if your IRA has lost value due to the drop in stocks over the past few months, your tax bill will drop along with it.

Here's an example that illustrates the potential tax savings of converting to a Roth IRA during a down market.

Suppose you're 55-years-old and you have a traditional IRA that was worth $1 million at the market's peak last year. You plan to retire in 10 years at 65, at which time you project that the IRA will be worth $2 million.

Due to the stock market retreat, your IRA has lost 20% of its value and is now worth $800,000. If you had converted when the market was at its peak, your tax bill would have been $250,000. But if you convert now, your tax bill would be just $200,000 –

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a tax savings of $50,000.

Now let's look out 10 years to retirement. You still expect your IRA to be worth $2 million based on long-term stock market trends. By converting to a Roth IRA now, you'd not only save $50,000 in current taxes, but you'll have $2 million in tax-free retirement income 10 years from now.

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Other Factors to Consider

There are a few other factors that could make now a good time for a Roth IRA conversion. One of these is your current tax bracket. If the new 2018 tax laws put you in a lower tax bracket than before, or maybe you're between jobs and thus have less income than usual, you could take advantage of the opportunity by converting now.

Now might also be a good time for a Roth IRA conversion if you plan to leave IRA assets to your kids and grandkids. Doing so would allow you to prepay income taxes for your heirs and not have to take any RMDs if you have other sources of income to meet your retirement living expenses. Plus, your family inherits the best gift of all – tax free investments.

Not Necessarily All or Nothing

Keep in mind that you don't have to convert your entire IRA to a Roth IRA. You can make a partial Roth IRA conversion, which would help reduce current taxes while also further diversifying your retirement savings.

Due to the big tax hit, Roth IRA conversions aren't for everybody. Please consult your fee-only fiduciary independent advisor for additional personal advice. But if you are planning one, the stock market swoon could make now a good time to do so.