Roth Conversions Amidst Market Turmoil

Take-Away: Now may be the time to make a Roth conversion while stock market values are low to reduce the income tax liability that comes with the Roth conversion.

Background: For those individuals currently agonizing over the stock market's gyrations, now is an excellent time to consider Roth conversions. We have covered the benefits of a Roth conversion in many prior missives, e.g., no lifetime required minimum distributions (RMDs), avoiding future income taxation, and passing Roth IRAs to beneficiaries without any income tax burden. However, the drawback to any Roth conversion is the concurrent obligation to pay income taxes 'up front' on the converted amount.

Roth Opportunity: The best time to make a Roth conversion of a traditional IRA is when the stock market is down. It is the equivalent of a *buy-low* scenario, where the Roth IRA owner enjoys the reward of tax-free growth when the market later rebounds. Accordingly, if an individual is considering a Roth conversion later in the year, they might want to accelerate that conversion process. Similarly, if an individual is currently engaging in 'dollar cost averaging' by converting a small amount each month or calendar quarter in an effort to smooth out volatility, they might want to increase their next conversion amounts. Other limitations are also at work in a 'down' market

No Recharacterization: It is important to remember that an individual can no longer recharacterize their Roth conversion after the 2017 Tax Act. Consequently, if an individual already converted a traditional IRA to a Roth IRA, they can no longer unwind that conversion when the value of stocks that were converted to the Roth IRA now have a much lower value. For those individuals who implemented a Roth conversion in early January, when stock values were much higher, they must still pay the income taxes due on the higher converted amount, despite the stocks' much lower market values.

Limited Capital Losses: In addition, some tax characteristics, like capital losses, may not be available to fully offset the taxable income from a Roth conversion. While pass-through losses can be used to offset income from a Roth conversion, selling non-qualified investments at a loss and thinking that the losses will help, will not be the case. Capital losses must first be used to offset capital gains, and any remaining capital losses can only offset up to $3,000 of the year's ordinary income, including Roth conversion taxable income.

Example: Ted is self-employed. Ted expects to have pass-through losses in 2025 based on his clients' reduced spending in the face of a feared recession. Ted's traditional IRA is currently invested 100% in the stock market. Ted initially planned to do a Roth conversion of his IRA later in 2025. However, by leveraging his elevated pass-through losses, Ted can offset significantly more income from a Roth conversion than he originally anticipated. Consequently, Ted uses the pass-through losses to his advantage, and he converts more of his traditional IRA to a Roth IRA than he had originally planned. In addition, Ted also has capital losses from his sale of some non-qualified stock that he owns, but Ted has no capital gains in 2025. Ted can only use up to $3,000 of those capital losses to offset the additional income that Ted will report from his Roth conversion.

Conclusion: Now may be a good time to engage in a Roth IRA conversion when stock prices are down. For those who are thinking about a conversion, they might want to accelerate that decision while values are low. Balanced against an accelerated decision to convert a traditional IRA to a Roth IRA is the risk that market values will go even lower, and a Roth conversion now is permanent, and it can no longer be recharacterized using 'hindsight.'

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