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Why Now May Be A Bad Time For A Roth Conversion

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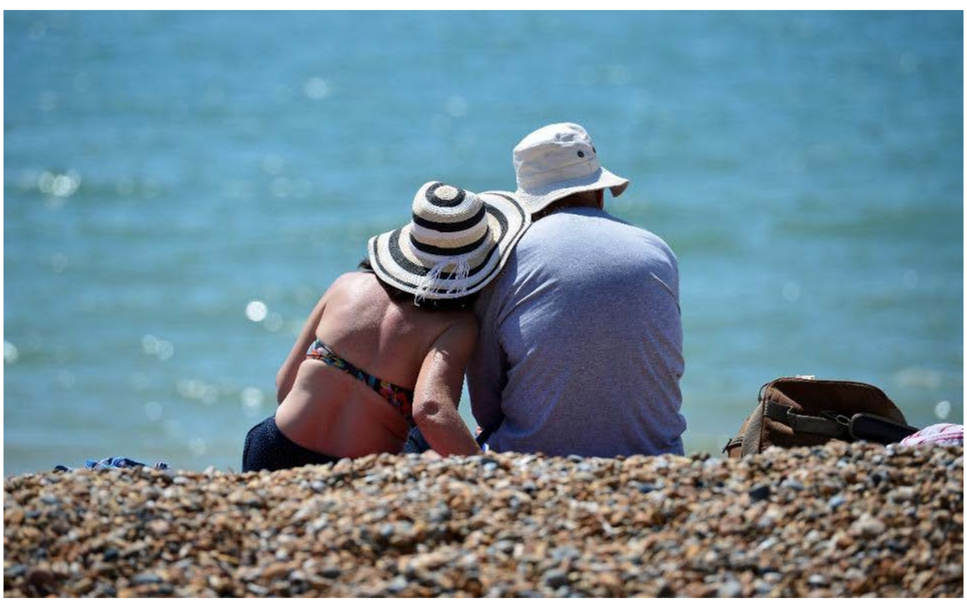
Roth IRAs and Roth 401(k) plans represent one of the few tax advantaged ways for Americans to invest. These Roth investment products allow you to make an after-tax contribution into an investment account. Subject to certain terms and conditions, they also allow for tax-free growth and tax-free withdrawal of dividends, interest, and capital gains. In this way, the Roth IRA and Roth 401(k) offer a very attractive "tax advantaged" opportunity.



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For many Americans, eligibility and/or access to the Roth investment products is a challenge. In order to participate in a Roth IRA, you have to meet IRS income eligibility requirements; if you make a high or even moderate middle-class income, you may not be eligible. In contrast, and perhaps surprisingly, the Roth 401(k) does not carry an income limitation; if your employer offers a Roth 401(k) provision in its retirement plan, you can participate regardless of your income level. Unfortunately, less than two-thirds of employers offer a Roth 401(k) option Aon Hewitt 2015 Trends. And for employers who do offer it, many fail to adequately educate their employees on its benefits.

A creative way for an individual to participate in a Roth IRA is known as a Roth conversion. This allows an investor with existing retirement plan balances (which have been funded with pre-tax dollars) to convert those balances into a Roth IRA.

There are, however, some reasons why right now may be a bad time to do a Roth conversion:

1. The stock market is at an all-time high. When you convert your existing retirement plan balances (e.g., 401(k), 403(b), IRA, etc.) into a Roth 401(k), you will incur a current-year, ordinary-income tax liability on the full amount of the converted balance. If you convert your investment account balance now, when your balance may be at historical high due to the run-up in stock prices, you will incur more taxes versus when your account balance is lower. It makes sense to convert an existing retirement plan into a Roth during a market correction (when the stock market is relatively low). For example, in hindsight, the late 2008 and early 2009 period may have been an excellent time for some to convert their IRA and 401(k) balances.

2. Income tax rates may decline. There is a lot of talk out of Washington about pending tax reform, including a potential drop in income-tax rates for individual earners. If this happens, then any Roth conversion completed now may be done under a higher tax system versus a potential lower-cost tax structure.

3. The government may limit pre-tax (non-Roth) contribution amounts. There has been some serious talk about the government proposing limits to the amount you can contribute to your pre-tax (non-Roth) 401(k) accounts. This would be part of an effort to collect more tax dollars now (as less income will escape immediate taxation). The government likes this tactic because it will collect higher tax revenue now while continuing to offer at least some support for retirement saving in a tax advantaged way. If this is enacted, investors may be more attracted to Roth-style retirement plans. So, because you may soon naturally gravitate toward using a Roth investment plan for your primary investment type, there may not be a pressing reason to convert your balances and incur a large current-year liability. These tax discussions are still in the debate stage, but it's something an investor should consider before converting and creating a tax liability.

Note that the government does allow a one-year look back (to October 15th of the year after the conversion) to re-characterize or reverse the Roth conversion IRA FAQs - Recharacterization of Roth Rollovers and Conversions. This is attractive, as it can protect you should the stock market significantly decline shortly after making the conversion. But if after converting there is a flat market, or even a continuation of a strong market followed by a bear market, the conversion may have been made near a market high—which would tend to at least somewhat negate the benefit from your conversion. Further complicating your conversion decision is that the ability to re-characterize a Roth conversion may be eliminated in a future tax bill.

All this underscores why selecting a Roth conversion is tricky, and any conversion should be done in close consultation with your tax and financial advisor.