NORTHERN TRUST
ASSET MANAGEMENT

CONSIDER A ROTH CONVERSION DURING MARKET DOWNTURNS

In general, investors should refrain from taking panicky actions when the market has plummeted. A better option is to stay the course while the market is stabilizing. Nonetheless, market downturns provide an opportunity to reshuffle assets to strategically manage tax bills. Specifically, a Roth conversion can be a beneficial action for investors who remain calm and thoughtful amidst the market chaos.

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Northern Trust Asset Management

THE CASE FOR ROTH CONVERSION DURING MARKET DOWNTURNS

The most recent market decline has been steep and quick with the U.S. stock market dropping by 30% in March 2020 from its most recent height. Such magnitude of value decline is painful. However, investors could pause and think whether they want to take advantage of the market dent to make a full or partial Roth conversion. This is not to encourage an exit at the bottom of the market and lock in the loss. Rather, investors could transfer their holdings from a traditional to a Roth account, when account values are likely lower, and thus pay less income tax on the converted assets than in normal times. If history is any guide, the markets will recover and rise over time. By then, the Roth assets will no longer be subject to income tax so the growth and withdrawal of those assets will be tax free.

ROTH CAN PROVIDE TAX DIVERSIFICATION

Let's clarify some basic rules. Traditional 401(k)s and individual retirement accounts (IRAs) allow investors to make pre-tax contributions, defer tax on investment returns, and then pay income tax on all withdrawals. Roth 401(k)s and Roth IRAs, in contrast, require that investors pay income tax on contributions up front and then accrue returns and make withdrawals with no tax obligations.

The eventual outcomes of traditional vs. Roth accounts depend on the future vs. present tax rates. If the future tax rate is lower, it is advantageous for investors to utilize traditional accounts to dodge the currently higher tax rate and pay at a lower rate in the future; conversely, Roth wins out.

It is hard to predict the trajectory of future tax rates. The U.S. income tax rates are currently lower than many other periods in history and have a good chance to rise. This makes a case for adding or utilizing Roth accounts in combination of traditional accounts to diversify the impact of tax and complement each other for a greater flexibility for future withdrawals.

HOW TO UTILIZE ROTH?

When contributing, an investor can direct new savings into Roth, paying income tax, while operating in a low income tax bracket; and switch to a traditional account, deferring income tax, when pay rises and the tax bracket jumps to a high-enough level to tip the scales.

Regarding the existing traditional accounts, investors could convert part or all of the assets into Roth accounts, if this move is deemed beneficial. This may not always be doable for 401(k) accounts, because not every company offers an in-plan Roth 401(k) option.

There is income tax due upon Roth conversions. Conversions count towards adjusted gross income for the year and are subject to ordinary income tax. Moreover, withdrawing an amount from the traditional 401(k) or IRA to pay the tax is deemed a distribution, which is subject to 10% penalty, if the withdrawal is earlier than age 59 ½. It is recommended that outside funds be used to cover such tax so that the 401(k)/IRA funds stay intact to grow.

For clarity, Roth 401(k) has no income limit for qualified employees to participate. In contrast, high-paid workers may not be eligible for contributing to an IRA. But the IRS does not prohibit the conversion of an existing traditional IRA to a Roth IRA. The 2017 tax reform blocks the reversal (recharacterization) of Roth IRA conversions, however, which was allowed in the past.

EXPECTED TAX BENEFITS OF ROTH

Roth accounts de facto enjoy a larger contribution limit. For instance, at a 25% tax rate, the after-tax $19,500 contribution limit for Roth 401(k) in 2020 is equivalent to $26,000 pre-tax for a traditional account. Note that traditional and Roth contributions combine to count towards the contribution limit for preferential tax treatments.

Ownership of both types of accounts can accommodate more flexibility. It allows investors to coordinate taxable and tax-free withdrawals, from traditional and Roth accounts, respectively, together with Social Security benefits, to minimize income taxes in retirement. Also, Roth accounts are not subject to the required minimum distribution (RMD), which is binding on traditional accounts at age 72 (previously 70 ½, as amended by the

Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019). Thus Roth accounts provide investors with more flexibility of withdrawals.

Roth accounts can assist with estate planning. Owners of Roth accounts effectively prepay income tax for heirs without owing any gift tax or using up the unified federal gift and estate tax exemption ($11.58 million for individuals in 2020, which is scheduled to revert in 2025 back to $5 million, adjusted for inflation). Distributions from inherited Roth accounts are not subject to income taxes. Assets intended for charitable bequests would not benefit from Roth conversion, because the donations are not taxed in the first place.

TIMING ROTH CONVERSIONS

A declining market environment provides investors with an opportunity to consider the possibility to make a full or partial Roth conversion of their retirement assets. This opportunity serves as a silver lining, in an otherwise challenging market environment, to take action and move assets to a Roth framework which may lead to significant financial benefits into the future.

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[1] *Assets under management for the Northern Trust Corporation as of December 31, 2019.*

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