

Converting a traditional IRA to a Roth IRA



Wealth Management

Roth IRAs can be attractive to taxpayers because qualifying distributions are tax-free, future tax management is flexible and required minimum distribution (RMD) rules do not apply to account owners. To take advantage of a Roth IRA's potential benefits, qualifying taxpayers can fund a Roth IRA through annual contributions, rollovers of "Roth" assets from an employer-sponsored retirement plan or by converting assets to a Roth IRA.

Who can convert?

You can convert assets in traditional IRAs, SEP IRAs and SIMPLE IRAs (SIMPLE IRA participant account must be funded for at least two years) to a Roth IRA. In addition, you can directly convert assets from a qualified employer retirement plan, such as a 401(k) or 403(b), to a Roth IRA, bypassing your traditional IRA.

However, the fact that you can convert assets to a Roth IRA doesn't necessarily mean that you should. There are a number of factors that you need to consider.

Why should you consider a Roth conversion?

Qualifying distributions from Roth IRAs are tax free

A distribution from a Roth IRA is a qualifying distribution and is completely tax free (and penalty free) if it is taken at least five years after you first establish a Roth IRA, and if one of the following applies:

- You are age 59½ or older
- You have a qualifying disability

- The distribution is taken for a qualifying first-time home purchase (\$10,000 lifetime limit)
- The withdrawal is made by your beneficiary, after your death

The five-year holding period begins on January 1 of the tax year in which you make your first contribution to any Roth IRA. Each taxpayer has only one five-year holding period for this purpose.

Withdraw contributions, tax-free

Even if you take a distribution that isn't a qualifying distribution, you may not be taxed on the full amount of the distribution. That's because when you withdraw funds from your Roth IRA, distributions are treated as consisting of your contributions first and investment earnings last. Since amounts that represent your contributions have already been taxed, they are not taxed again when you take a distribution from the Roth IRA. Only the portion of a non-qualified distribution that represents earnings will be taxed and possibly penalized.

A distribution representing your annual contributions will not be subject to the 10% premature distribution penalty. However, in the case of a conversion, the 10% premature distribution penalty may apply if you withdraw funds from your Roth IRA within five years of the conversion, and no exception to the penalty applies.

No RMDs for account owners

You and your spouse are not required to take any distributions from your Roth IRAs during your lifetime(s). This can be a significant advantage in terms of your estate planning and may be a good reason to consider converting funds. Most designated non-spouse beneficiaries will be required to distribute the Roth IRA in its entirety by no later than December 31 of the tenth year following the year in which the Roth IRA owner died. There is an exception for eligible designated non-spouse beneficiaries, who are still generally able to "stretch" the RMDs over their individual remaining single-declining life expectancies.

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Future tax management flexibility

For a number of reasons, many individuals believe that their personal tax rate will likely increase in the future. It could be that you are relatively young and expect your salary to rise, you think tax rates will increase in the future, or you expect that in retirement your taxable income will be as high—or higher—than it is today. A Roth IRA allows you to protect your retirement savings from the prospect of rising taxes and provides you with greater tax management flexibility in the future.

Qualified distributions from Roth IRAs are not included when determining the taxable portion of Social Security

Converting assets to a Roth IRA may be beneficial when you begin receiving your Social Security benefits. The portion of your Social Security (if any) that is taxable depends on your MAGI and federal income tax filing status in a given year. Under current law, qualified distributions from Roth IRAs are not included when determining the taxable portion of your Social Security.

Considerations

Taxes

The assets you convert are subject to federal and possibly state income tax for the year you convert (to the extent that the converted amount represents pre-tax assets). Therefore, even if it makes overall financial sense to convert assets to a Roth IRA, paying the taxes now may not be desirable.

Using IRA funds to pay your tax bill

If you have to cash out part of your traditional IRA to pay the income tax that results from converting assets to a Roth IRA, the benefits of the conversion are substantially reduced. Using IRA dollars to pay the tax reduces the amount of assets in your IRAs, potentially jeopardizing your retirement goals. In addition,

the IRA funds that are distributed but not converted may be subject to a 10% premature distribution penalty. Paying your income tax bill with non-IRA funds is generally more advisable.

Converting after-tax assets

If you have made only deductible contributions to your traditional IRAs, then the entire amount that you convert will be taxable. However, if you have ever made non-deductible (after-tax) contributions to your traditional IRA, those contribution amounts, or basis, will not be taxable when converted since they have already been taxed. Keep in mind, if you have multiple IRAs, they are aggregated for this purpose. (This includes traditional, SEP and SIMPLE IRAs.)

Application of the 10% premature distribution penalty

The 10% premature distribution penalty does not apply to assets that you convert to a Roth IRA, even if you convert the assets before reaching age 59½. Any amount distributed that is not converted (for example, funds used to pay your tax bill) may be subject to the 10% premature distribution penalty.

However, if you convert assets to a Roth IRA and withdraw any portion of those funds from the Roth IRA within five years, and an exception to the penalty does not apply, the withdrawal will be subject to the 10% premature distribution penalty, to the extent those funds were taxed at the time of the conversion.

Distribution ordering

Distributions from Roth IRAs are subject to ordering rules. They are considered distributed in the following order:

1. Regular annual contributions
2. Converted amounts on a first-in, first-out basis (taxable portion first)
3. Earnings

Example: Sam, who is age 38, contributed \$6,000 to his Roth IRA in 2017. In 2018, Sam converted \$10,000 from his traditional IRA to his Roth IRA, and included this \$10,000 in his 2018 gross income. He made no further contributions to his Roth IRA. In 2023, Sam takes a \$10,000 distribution from his Roth IRA that is valued at \$16,000. None of the exceptions to the 10% premature penalty distribution apply. Sam's \$10,000 withdrawal is considered to consist first of his \$6,000 annual contribution made in 2017. Sam owes no 10% premature distribution penalty on this \$6,000. The remaining \$4,000 of Sam's \$10,000 withdrawal is considered to consist of funds derived from his conversion, and is subject to a 10% premature distribution or recapture penalty.

Questions and answers

Can I convert if I am over age 73?

You can convert assets to a Roth IRA regardless of your age. However, you cannot convert your RMD to a Roth IRA—it must be distributed to you prior to your conversion.

Can I do a partial conversion?

Yes, you can convert only a portion of your traditional IRA to a Roth IRA. The funds you convert to the Roth IRA will be subject to federal income tax. If you have ever made non-deductible (after-tax) contributions to your IRA, you have to calculate what portion of the funds that you convert represents non-deductible contributions. Because those amounts were already taxed, they will not be taxed again when converted to a Roth IRA.

How do I calculate the portion of my conversion that represents non-deductible contributions (pro-rata rule)?

If you have ever made non-deductible contributions to your traditional IRAs, you calculate and report the taxable and non-taxable portions of the

converted funds using IRS Form 8606. Basically, you calculate the ratio of all your non-deductible contributions to the total balance of all of your traditional IRAs, including SEP IRAs and SIMPLE IRAs. That ratio is then applied to any distribution from any of your traditional IRAs, including a conversion to a Roth IRA. So, if 30% of the total balance of all of your traditional IRAs represents non-deductible contributions, 70% of the funds that you convert to a Roth IRA would be taxable, and 30% would not.

Can I convert only my non-deductible IRA?

No, the IRS makes you aggregate all your traditional IRAs (including SEPs and SIMPLEs) when calculating the taxes due whenever you take a distribution from (or convert) any of your IRAs.

Can a decedent IRA be converted to a Roth IRA?

Yes, as long as the beneficiary in question is the surviving spouse who assumed assets into a beneficiary IRA structure.

Traditional IRA assets inherited by a non-spouse beneficiary are not eligible to convert to an inherited Roth or Roth IRA.

However, a non-spouse beneficiary inheriting a qualified plan (401(k), pension, profit sharing) can convert these assets to a decedent Roth IRA by doing a direct conversion from the qualified plan.

Conclusion

A Roth IRA can be an excellent way to help you fund the type of retirement you dream of. Your financial advisor will work with you and your tax and legal advisors to assess your current situation, your assets, goals and objectives, and assist you in determining if converting assets to a Roth IRA is the right strategy for you. They will also provide you with the information you need in order to make your investment decisions.



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