Converting a Traditional IRA to a Roth IRA

The case for converting, and how to do it

While Roth IRAs currently comprise only a small fraction of the total $11 trillion IRA market, they are poised to grow as a result of recent tax law changes. As investors become more concerned about the impact of taxes in retirement, Roth IRAs present a tax-free income alternative. Unlike most retirement accounts, Roth IRAs feature withdrawals that are free from federal income taxes, making them an attractive vehicle for a wide range of retirement savers.

Roth conversions available to everyone

When the Roth was first introduced in 1998, tax filers earning more than $100,000[1] were ineligible to convert their tax-deferred retirement accounts to Roth IRAs. But beginning in 2010, that income cap was eliminated, making Roth IRAs available to all investors. Converting to a Roth IRA is a taxable event — federal income taxes are due on the value of pretax contributions and any earnings.

[1] Income limits were based on modified adjusted gross income (MAGI).

All tax-deferred IRAs, including Traditional, Rollover, SIMPLE[2], SEP, and SAR-SEP IRAs, are eligible for a Roth IRA conversion. Tax legislation enacted in early 2013 also expands in-plan conversions of traditional 401(k) and 403(b) assets to designated Roth accounts to include all participants in a plan. Previously, plan participants were required to have a "distributable" event (i.e., attainment of age 59½) in order to convert. In-plan conversions may only be made available to plans that already offer the Roth 401(k) option for salary deferrals. Plans are not mandated to offer the conversion option.

[2] SIMPLE IRAs may not be converted until two years from the date the account owner first began participating in the plan.

The case for converting

The tax treatment of withdrawals is the biggest difference between Roth IRAs and other retirement savings vehicles. For that reason, investors considering converting to a Roth IRA will often ask themselves whether their tax liabilities are likely to be higher now or in retirement. Making that kind of prediction is a difficult task, and one that can often be based on flawed assumptions. For example, many individuals are finding that they want to work at least part-time during their retirement years for a variety of reasons. That income — combined with income from Social Security, any annuities, and required minimum distributions from Traditional IRAs — may put you in a higher tax bracket than you anticipate. Moreover, if tax rates increase between now and the time you retire, earning less income would not necessarily mean you'll owe less in income taxes.

Your taxes may go down if:

- You expect to stop working (or only work part-time) and, therefore, would earn less and be in a lower tax bracket
- You plan to move to a state that has lower, or no, state income taxes
- You plan on moving to a larger home, increasing the amount of deductible interest you can claim
- You expect to have significant deductible health-care expenses

Your taxes may go up if:

- You plan to pay off your mortgage or move to a smaller home, therefore decreasing the amount of deductible interest you can claim
- You expect to receive significant income from large lump-sum retirement plan payments, IRAs, or annuities
- You plan to liquidate taxable investment savings or other assets
- You plan to move to a state with higher income taxes

For investors who can afford the taxes due on a conversion, Roth IRAs offer a number of compelling benefits:

1: Tax diversification

Most investors understand the benefits of diversifying their portfolios by spreading their assets among a variety of investments. But not all investors consider how to diversify their tax liability by spreading assets among taxable, tax-deferred, and tax-free accounts. Often, investors hold a disproportionate percentage of their assets in tax-deferred accounts, such as Traditional IRAs and 401(k)s, with little or no assets in tax-free retirement vehicles, like a Roth IRA.

2: No required minimum distributions (RMDs)

The fact that Roth IRAs offer tax-free withdrawals is just one appealing feature. Roth IRAs also are more flexible savings vehicles, with no RMDs starting at age 72. While widespread double-digit market declines such as those of 2008 are uncommon, they're not unheard of, and mandatory taxable withdrawals from one's retirement account only compounds the problem of market volatility. The ability to choose when and how much to withdraw from your retirement account can be a valuable feature, and it is one Traditional IRAs don't offer.

3: Leave a tax-free legacy to the next generation

Since there are no distributions required for the account owner or spousal beneficiary, more assets may be left in the Roth account for potential tax-free growth. For this reason, many affluent individuals looking to maximize the legacy they leave their beneficiaries may find Roth IRAs attractive. Non-spouse beneficiaries are required to take minimum distributions from the Roth IRA; however, these proceeds are free of income taxes as long as the account has been established for at least five years.

Calculating taxes

On a conversion

In many cases, the Traditional IRA or retirement plan being converted will consist of pretax contributions and earnings. In such cases, the entire amount converted — contributions plus earnings — will be taxable as ordinary income.

In some cases, an investor may hold "after-tax" funds in his or her IRA, such as in a non-deductible IRA. Since the contributions were previously taxed, only subsequent earnings would be taxable on a conversion to a Roth IRA.

Example 1

ASSUMPTIONS

- Investor owns a non-deductible IRA, valued at $20,000
- The non-deductible IRA includes $10,000 in after-tax contributions and $10,000 in earnings
- The investor does not own any other IRAs (including a SEP IRA or a SIMPLE IRA)
- The investor would like to convert the $20,000 non-deductible IRA to a Roth IRA

RESULTS

- $10,000 in after-tax contributions are not taxed
- $10,000 in earnings are taxable at ordinary income tax rates at the point of conversion

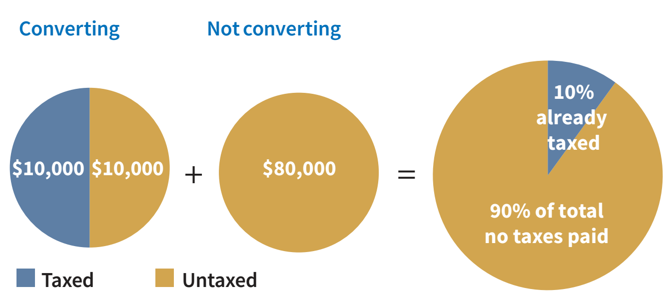
For investors with multiple IRAs

If the investor owns a non-deductible IRA and holds assets in other IRAs, figuring the taxes due upon converting to a Roth IRA becomes more complex. For the purpose of calculating the taxes at conversion, all IRA accounts must be considered in aggregate. To figure the taxes due, you need to determine which IRA assets have been previously taxed. Here's how it works:

Example 2

ASSUMPTIONS

- Investor wants to convert an IRA consisting of $10,000 in non-deductible contributions and $10,000 in earnings ($20,000 total value)
- Investor also owns a Rollover IRA valued at $80,000, which he does not wish to convert



RESULTS

- If the investor converts $20,000 to a Roth IRA, 90% ($18,000) would be considered taxable income upon conversion and 10% ($2,000) would be considered after-tax IRA assets and not taxed. In this case, the IRS considers the amount being converted to be a pro rata portion of pretax IRA assets and after-tax IRA assets.

Important considerations before converting to a Roth IRA

It is generally not a good idea to convert to a Roth IRA unless you have other funds available outside of your retirement accounts to pay the taxes. Otherwise, you will likely be forced to use some of the assets in your Traditional IRA or 401(k) to pay the taxes, which could trigger an early withdrawal penalty on those assets and create an even greater tax burden, as well as decrease the size of your retirement nest egg.

A partial conversion can reduce your tax bill

If you find that converting an entire account to a Roth IRA creates too large a tax burden, you may want to consider a partial conversion. A partial conversion may allow you to avoid being pushed into a higher tax bracket as a result of the increase in your reported taxable income. But be sure to consider the effects a conversion may have on your adjusted gross income (AGI). For example, an increase in AGI may:

- Cause Social Security benefits to be taxable
- Subject investment income to the 3.8% Medicare surtax
- Negatively impact itemized deductions like medical expenses
- Disallow certain tax credits
- Result in higher Medicare Part B or Part D premiums

Distributions from a Roth conversion account

In order for a distribution to be free of taxes and penalties, it must be considered "qualified." A qualified Roth distribution must meet both of these criteria:

- The investor has held any Roth IRA for five years, AND
- There must be any ONE of the following "qualifying events": reaching age 59½, first-time home purchase ($10,000 lifetime limit), or disability or death of the account owner.

The following chart provides details on taxes and possible penalties for distributions from a Roth conversion account that do not meet both of these criteria (i.e., "non-qualified" distributions):

SCENARIO	CONVERSION AMOUNT	EARNINGS
1 **Account converted less than 5 years ago and no exception applies**	No taxes, but a 10% penalty applies	Taxed as income + 10% penalty
2 **Account converted at least 5 years ago and no exception applies**	No taxes or penalty	Taxed as income + 10% penalty
3 **Account converted less than 5 years ago and exception applies**	No taxes or penalty	Taxed as income, no 10% penalty

Exceptions include the qualifying events described above and certain medical expenses, qualified higher education expenses, certain payments to purchase health insurance in cases of unemployment, and periodic payments utilizing IRS rule 72(t). Additionally, special rules apply to determine the order in which Roth contributions, conversions, and earnings are withdrawn. Consult with a tax professional for assistance.

An important update on Roth IRA recharacterization

Roth IRA recharacterization is a rule that essentially allows investors to undo a conversion or contribution from a Traditional IRA or other retirement account to a Roth IRA. The passage of the Tax Cuts and Jobs Act (TCJA) in late 2017 eliminates the option to recharacterize a Roth IRA conversion beginning in 2018 (recharacterization of Roth IRA *contributions* is still available). This means that IRA owners considering a conversion to a Roth IRA must carefully analyze the transaction since there is no flexibility to undo the transaction after the fact.

A tax benefit for certain business owners

Business owners who claim deductions that total more than their income in a given year may record a net operating loss (NOL). Net operating losses may result from high startup costs associated with launching a new business, large first-year depreciation deductions, or significant business losses for existing businesses. An NOL is carried forward for tax purposes (for an unlimited number of years).

For taxpayers with NOL being carried forward for tax purposes, a Roth conversion may be an attractive strategy since the income generated from the conversion could be partially offset by the NOL. In essence, one could convert tax-deferred retirement assets to a Roth with lesser tax consequences for that particular year. Complex tax rules govern reporting an NOL, so consult with a tax professional for guidance.*

*Passage of the CARES Act in April 2020 temporarily modifies rules for NOLs arising for tax years 2018, 2019, or 2020. For these tax years, NOLs can be carried back a maximum of five tax years in addition to being carried forward. Also, for these years, taxpayers can utilize an NOL to offset a maximum of 100% of taxable income in one tax year. The 80% of taxable maximum limit will apply beginning in 2021.

Your financial representative can help

Converting some or all of your tax-deferred retirement assets to a Roth IRA may yield significant benefits down the road. However, there are many considerations that should go into such a decision, and the best way to find out how such a decision may affect you is to talk to your financial representative. He or she can discuss your specific situation, as well as recent changes in the tax law, and how you can take advantage of them as you prepare for a secure financial future.

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