

Roth IRAs

Why Should I Convert Traditional IRA Funds into a Roth IRA?

Questions & Answers

Why is now the right time?

Marginal income tax rates are relatively low on a historical basis. The sooner you do your conversion, the sooner your Roth IRA can commence the earning of tax-free income.

Why convert my traditional IRA to a Roth IRA?

The income earned by the funds within a Roth IRA will be tax free to you or your beneficiaries when withdrawn as a qualified distribution. The income earned within your traditional IRA is generally taxable when withdrawn.

Example: You have \$10,000 in your traditional IRA as of January 2015. You can certainly leave the funds within your traditional IRA and allow them to grow. Assume this \$10,000 grows in value to \$50,000 over the next 18 years.

The \$40,000 of income will be taxable whenever it is withdrawn from a traditional IRA. However, if you had converted or moved this \$10,000 to a Roth IRA, the \$40,000 of income will never be taxed if the funds are withdrawn as a qualified distribution.

No matter how great your income or how wealthy you are, it will be tax free if the distribution from the Roth IRA is a qualified distribution. As discussed below, you are generally required to pay income tax with respect to the \$10,000 for the year the conversion occurs.

Who is eligible to do a conversion?

Beginning January 1, 2010, the conversion requirements, were repealed, and anyone having a traditional IRA may convert funds from their traditional IRA to a Roth IRA. An individual's RMD for the current year is ineligible to be converted.

What distributions from a Roth IRA will be tax free?

"Qualified distributions" will be tax free. To be a qualified distribution, the distribution must occur after you have met the five-year holding requirement, and the distribution is made to you (1) after you have attained age 59½, (2) after you have become disabled, (3) because of a first-time home purchase, or (4) to your beneficiary after your death.

When will I have met the 5-year rule?

The five-year period is considered to start on January 1 of the year for which the first contribution to a Roth IRA is made. All Roth IRA contributions, including rollovers and conversions, are aggregated for purposes of satisfying the 5-year rule.

Does the law define the order for distributions?

Yes. The law mandates the following order for distributions: (1) from regular/annual contributions; (2) from conversion contributions on a first-in-first-out basis and (3) from earnings. The order is determined as of the end of the taxable year, and each category must be exhausted before the next is used. With respect to a conversion contribution, it is treated as being made first from the portion, if any, that was includible in gross income as a result of the conversion.

How much may I convert from my traditional IRA?

There is no dollar limit on the amount which you may convert from your traditional IRA to a Roth IRA.

Note that you are not required to convert the total amount of your traditional IRA in one year. It is possible, to convert only a portion of your traditional IRA balance over a period of a years.

Example: If you have \$50,000 in a traditional IRA, you may wish to convert \$10,000 a year for a period of 5 years, or \$5,000 a year for a period of 10 years.

How do I convert my traditional IRA?

You can convert amounts from your traditional IRA to a Roth IRA by using any of the following three methods. The first method is the standard rollover. You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days of the distribution. The second method is a trustee-to-trustee transfer. If permissible, you may direct the custodian/trustee of your traditional IRA to transfer an amount from the traditional IRA to the custodian/trustee of your Roth IRA. The third method is an internal movement. You direct the custodian/trustee of your traditional IRA to transfer an amount from your traditional IRA to your Roth IRA.

Whatever conversion method is used, the custodian/trustee of the traditional IRA will prepare a Form 1099-R to report the distribution, and the custodian/trustee of the Roth IRA will prepare a 5498 to report the conversion contribution.

How do I convert my SEP-IRA or SIMPLE-IRA?

You would follow the same procedures which apply to converting funds from a traditional IRA. However, in the case of a SIMPLE IRA, you may convert such funds only after a 2-year period has expired. Such period commences on the date of the first contribution made to your SIMPLE-IRA.

Do I need to execute a new Roth IRA plan agreement to receive the conversion contribution?

No. You could establish a new Roth IRA plan agreement if you wanted, but this is not required. If you already have an existing Roth IRA, you could add the conversion funds to your existing Roth IRA.

Must I or should I establish a separate Roth IRA?

A conversion contribution may be made to the same Roth IRA to which regular annual Roth IRA contributions have been or will be made.

However, if you convert certain assets from your traditional IRA to your Roth IRA, but later decide to recharacterize (i.e. undo) this conversion, it is easier to do this if the contribution had been to a separate Roth IRA rather than being combined with other Roth IRA funds.

What income tax will I owe because of a conversion?

You must include in your gross income (at your applicable marginal tax rate) distributions from a traditional IRA that you would have had to include in income if you had not converted them into a Roth IRA. That is, you are deemed to have received a distribution and you are required to pay tax on such amount. For example, assume your marginal tax rate is 15%. If you convert \$10,000 from your traditional IRA to a Roth IRA, you will pay tax of \$1,500 with respect to converting the \$10,000.

If the distribution includes any basis (i.e. nondeductible contributions), you do not include such after-tax amounts in your gross income.

What if I am currently ineligible to make an annual contribution to a Roth IRA?

You still may be eligible to make a Roth IRA conversion contribution. As follows, you make a nondeductible traditional IRA contribution and then immediately convert it to a Roth IRA. You will owe no income tax as your contribution was made with after-tax funds. Being able to move these funds to your Roth IRA is a very desirable tax result. In order to receive the maximum tax benefit you must not have any other funds currently in another traditional IRA, SEP-IRA, or SIMPLE-IRA. If you would have other such funds, you should discuss with your tax advisor.

Will I owe the 10% additional tax for my conversion if I am under the age of 59^{1/2}?

No.

May there be amounts in my traditional IRA which I am not eligible to convert?

Yes. You cannot convert any required distribution amount.

May I convert an IRA which I inherit from my spouse?

Yes. If you roll over your deceased spouse's IRA into your own traditional IRA, then you may convert it to a Roth IRA. In the same way, if you are eligible to elect to treat your deceased spouse's IRA as your own, then you may so elect and then convert it to a Roth IRA.

May I convert an IRA which I inherit from someone who is not my spouse?

No. If you inherited a traditional IRA from someone other than your spouse, then you are ineligible to convert such an IRA to a Roth IRA.

If I have set up a substantially equal periodic payment with respect to a traditional IRA, am I eligible to convert some or all of this IRA?

Yes, but you must continue the periodic payments.

What tax reporting forms will be prepared by the one or two IRA custodians/trustees?

Regardless which of the three conversion methods is used, there is either an actual distribution which occurs or a deemed distribution which is deemed to have occurred. The custodian/trustee of the traditional IRA is to prepare a Form 1099-R to report the distribution. The IRS instructs the custodian/trustee to use a reason code "2" if you are not yet age 59½ or older and a "7" if you are age 59½ or older. The custodian/trustee of the Roth IRA is to report the amount of the conversion contribution in box 3 of the Form 5498 for the year during which the conversion was made.

What income tax forms will I need to complete to properly reflect a conversion on my federal income tax return?

You will need to complete Form 1040 and Part II of Form 8606 (Nondeductible IRAs). Part II is titled, "Conversions from Traditional, SEP or SIMPLE-IRAs to Roth IRAs".

Is there an age limit imposed for doing a conversion?

No, a person is eligible to do a conversion at any age. However, as discussed previously, you are not eligible to convert any required distribution.

Is there any IRS limit on the number of conversions I may do?

No.

If I convert some or all of my traditional IRA, do I have the right to change my mind and undo the conversion, or can I only undo it if I become ineligible?

You have the right to change your mind. You can undo it even though you were eligible to do the conversion. You must move the funds from the Roth IRA, by a recharacterization, into a traditional IRA, by the due date for your tax return for the year during which the conversion was made, including extensions. You may either recharacterize the entire conversion amount, or you may recharacterize only a portion of the conversion amount. You must also include the related earnings, from the date of the conversion. You will need to report the recharacterization on your tax return, but no portion will be required to be included in income. The

net tax effect of a conversion and subsequent recharacterization is that a conversion is treated as if it had never occurred.

What is a reconversion?

A reconversion is when you do a conversion, recharacterize it and then do another conversion. You cannot reconvert an amount during the same taxable year or, if later, during the 30-day period following a recharacterization.

If I withdraw money from my Roth IRA a number of years after the conversion, will I have to pay a special 10% additional tax if I am younger than age 59½?

Unless you are exempt from the 10% special tax because you qualify for one of the exceptions, you will have to pay the 10% tax if, after applying the special tax-ordering rules, you are considered to have withdrawn your “conversion” funds, and you have not satisfied a special five-year rule. For this special rule, the five-year period starts on January 1 of the year during which you made the conversion contribution. A separate five-year period applies to each conversion you make.

Once you have satisfied this special five-year rule, you will NOT have to pay the 10% tax even if, after applying the special tax-ordering rules, you withdraw your “conversion” funds when you are younger than age 59½.

For example, you are age 39 and you converted \$20,000 on June 10, 2012. You did not owe the 10% tax when you did the conversion. However, if you withdrew this conversion on August 14, 2015, you would owe the 10% additional tax on the \$20,000 as you did not meet the special 5-year rule. If you withdraw this conversion on or after January 1, 2017, the 10% tax will not be owed as it applies only to any withdrawal of the conversion occurring between June 10, 2012 and December 31, 2016. This is true even if you would be only age 44.

Are there any other tax situations of which to be aware?

If you do not convert 100% of your distribution and you are younger than age 59½, you will owe the 10% excise tax on the amount not converted even if that amount is withheld as federal income tax. For example, you have \$10,000 in a traditional IRA and you convert \$9,200 and you have \$800

withheld. The law expressly provides that the 10% additional tax does not apply to any conversion amount. However, only \$9,200 was converted. The \$800 which was used to pay the income taxes was not converted and must be included in your income for income tax purposes. In addition, you will owe an additional \$80 ($\$800 \times 10\%$) in taxes which you may not have planned on owing because the 10% does apply to the \$800.

Must I take a required minimum distribution from my conversion Roth IRA?

No. A Roth IRA accountholder is not subject to any required distribution rules.

What happens to my Roth IRA after I die?

If your spouse is your beneficiary, most likely he or she will elect to treat your Roth IRA as his or her own Roth IRA since he or she is not required to take a distribution while alive. However, if you have designated one or more nonspouse beneficiaries, then he or she generally must commence taking required distributions over his or her life expectancy by December 31 of the year after you die. As long as the 5-year rule has been met by either you or your beneficiary, a distribution to your beneficiary is tax-free.

Again, your Roth IRA will generate tax-free income for your beneficiary(ies) for their life span. This assumes the federal income tax law is never changed to impose an income tax on the earnings of your Roth IRA. Your beneficiary most likely will wish to withdraw only the required minimum amount for each year commencing with the year after you die. Except in very rare situations, you do not wish to designate your estate as the beneficiary of your Roth IRA as a special tax rule requires the Roth IRA to be closed under the 5-year rule and the right to earn tax-free no longer applies.

The information provided in this brochure is not intended to be legal or tax advice. You should consult your attorney or tax advisor for information that relates to your specific circumstances.