Getting Rid of Basis Within a Traditional IRA
so a Person can Convert Only the Non-taxable Funds

There are individuals who have basis within one or more of their traditional IRAs. Remember that a person who has multiple traditional IRAs must aggregate all of them in applying the taxation rules when there is a distribution from one of more of the traditional IRAs.

Illustration. John Doe had $42,000 within his 401(k) plan; $32,000 was taxable (pre-tax) and the other $10,000 was nontaxable (after-tax or basis). He had directly rolled over the $42,000 into his traditional IRA in 2011. He had not used the planning technique as discussed in the article, “Moving Nondeductible Funds From a 401(k) Plan into a Roth IRA” as set forth in the July newsletter. Since 2011, there has been $8,000 of earnings within the traditional IRA. The IRA balance is now $50,000 and $10,000 is basis.

On page 5 is discussed the topic that a person is subject to the RMD rules may reduce his or her required distributions for a number or upcoming years by rolling over traditional IRA funds into a 401(k) plan.

This article is being written to illustrate that a person who has basis within his or her traditional IRA can isolate this basis by rolling over the “taxable” traditional IRA funds into a 401(k) plan or other pension plan. The individual may then convert this basis to a Roth IRA. Every taxpayer who is able to do this will want to do this. A two/three step process must be followed.

Step One. He rolls over or directly rolls over $40,000 from his IRA to the 401(k) plan. The rollover rules do not allow him to rollover the $10,000 of non-taxable funds within the traditional IRA to the 401(k) plan.

Step Two. He may now convert the $10,000 to his Roth IRA. No income tax is owed and the $10,000 in the Roth IRA will now be invested so that tax-free income will be earned. As long as there is a qualified distribution, it will be tax free.

Now that John has no taxable money within his traditional IRA, he most likely also will want to make a non-deductible traditional IRA contribution of $5,500 or $6,500 and convert such amount.

Step Three. This step is optional. After a short period of having these funds within the 401(k) plan back into the same or another traditional IRA as long as the 401(k) plan would permit it. The key element of these planning techniques is, he must be eligible to make a rollover contribution into a 401(k) plan or another pension plan. If an individual does not have an employer who sponsors a 401(k) or other pension plan allowing such rollovers, but he has self-employment income from a business activity, he may set up his own 401(k) or pension plan so that such rollover may be made.