



Roth IRAs



Understanding Roth IRA Conversions

Questions & Answers

Why convert my traditional IRA, SEP IRA, or SIMPLE 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The income earned by the funds within a Roth IRA will be tax free to you or your beneficiaries when withdrawn as a qualified distribution. The income earned within your traditional IRA is generally taxable when withdrawn.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 2021. 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The \$40,000 of income will be taxable whenever it is withdrawn from a traditional IRA.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if you had converted or moved this \$10,000 to a Roth IRA, the \$40,000 of income will never be taxed if the funds are withdrawn as a qualified distribution.

Who is eligible to do a conversion?

Beginning January 1, 2010, the conversion eligibility requirements, were repealed, and anyone may convert funds from their traditional IRA, SEP IRA, or SIMPLE IRA to a Roth IRA. An individual's RMD for the current year is ineligible to be converted. A person is eligible to convert a SIMPLE IRA only if the 2-year requirement has been met.

Why might now be the right time?

Marginal income tax rates are relatively low on a historical basis. Congress and the President may enact new tax legislation increasing these rates. The sooner you do your conversion, the sooner your Roth IRA can commence the earning of tax-free income.

Should I consult with my legal or financial adviser?

Yes. The tax rules for Roth IRA conversions are complicated and a Roth IRA conversion once made is irrevocable. The purpose of this brochure is to make you aware that this special tax transaction exists. You and your advisers must decide if you will benefit by making a Roth IRA conversion.

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 59^{1/2}, (2) after you have become disabled, (3) because of a first-time home purchase, or (4) to your beneficiary after your death.

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 a portion of your traditional IRA balance over a period of a years.

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

You 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.

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 may add the conversion funds to your existing Roth IRA.

What income tax will I owe because of a conversion?

The general tax rule is, 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 22%. If you convert

\$10,000 from your traditional IRA to a Roth IRA, you will pay tax of \$2,200 with respect to converting the \$10,000.

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

In certain federally declared disaster situations you may qualify for a disaster distribution which would allow you to include the distribution amount in your income over a 3 year period (1/3 each year). This special tax rule is beyond the scope of this brochure. You must consult with your tax advisor.

What are the three possible conversion situations?

The first situation is: all the funds within your IRA(s) are taxable because you have only made deductible contributions. The second situation is: your IRA(s) has both taxable funds and nontaxable funds non-deductible contributions have been made. The third situation is: all the funds within your IRA are non-taxable because you have made a non-deductible contribution and then you convert it immediately or you have isolated the non-deductible contributions by rolling over the taxable funds into an employer plan.

When I take a distribution from my traditional IRA, SEP-IRA or SIMPLE-IRA how is it taxed?

General Rule. Distributions from your traditional IRA may be fully or partly taxable, depending on whether your IRA includes any non-deductible contributions or other basis.

If you have one or more traditional IRAs, one or more SEP-IRAs or one or more SIMPLE-IRAs, then you are required to aggregate all of these IRAs for purposes of applying the pro rata IRA distribution taxation rule.

Fully taxable. If only deductible contributions were made to your traditional IRA (or IRAs, if you have more than one), you have no basis in your IRA. Because you have no basis in your IRA, any distributions are fully taxable when received.

Partly taxable. If you made non-deductible contributions to any of your traditional IRAs, you have a cost basis (investment in the contract) equal to the current balance of those non-deductible contributions. These non-deductible contributions are not taxed when they are distributed to you. They are a return of your investment in your IRA. Until all of your basis has been distributed, each distribution is partly non-taxable and partly taxable.

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

Although you may be ineligible to make an annual Roth IRA contribution due to your high income, you are eligible to make a non-deductible traditional IRA contribution. If you currently have no other funds in a traditional IRA, SEP-IRA or SIMPLE-IRA you may then convert immediately such contribution and you will owe no income tax. This transaction is sometimes called the backdoor Roth IRA contribution. Being able to move these funds into your Roth IRA is a very desirable tax result. If you have other funds in a traditional IRA, SEP-IRA or SIMPLE-IRA the pro-rata distribution tax rule will apply. Any conversion you make will be partially taxable and partially non-taxable.

Is it possible to move the taxable funds to a 401(k) Plan so only the nontaxable funds remain in the traditional IRA and may be converted?

Yes. Assume Jane has three traditional IRAs with a total balance of \$75,000 and her basis is \$15,000. Her current employer sponsors a 401(k) plan which will accept a rollover or a direct payment of taxable funds from a traditional IRA. This means she can rollover her taxable amount of \$60,000. This also means her basis of \$15,000 remains in the traditional IRAs and she may convert it to her Roth IRA and no tax is due.

In some cases Jane will be the employer and she can have the plan written to authorize such a rollover.

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.

Does the law define the order for distributions from a Roth IRA?

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.

When will I have met the 5-year rule for qualified distribution purposes?

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 considered for purposes of satisfying this 5-year rule. Example: Jill converted \$2,000 on July 10, 2021. This was her first Roth IRA contribution. She will have met this 5 year requirement as of January 1, 2025.

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?

Yes. 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, a second 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.

Is there any other tax situation of which to be aware?

If you do not convert 100% of your taxable 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 \$9,000 and you have \$1,000 withheld. The law expressly provides that the 10% additional tax does not apply to any conversion amount. However, only \$9,000 was converted. The \$1,000 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 \$100 (\$1,000 x 10%) in taxes which you may not have planned on owing because the 10% does apply to the \$1,000.

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 substantially equal 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 (Non-deductible 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?

No, commencing with tax year 2018, a person making a Roth IRA conversion contribution cannot undo it by recharacterizing it. A Roth IRA conversion contribution is irrevocable.

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

No. A Roth IRA 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 non-spouse beneficiaries, then certain beneficiaries will continue to be able to use the life distribution rule, but many beneficiaries will be required to close the inherited Roth IRA by December 31 of the year containing the tenth (10th) anniversary of your death. Only an eligible designated beneficiary is entitled to use the life distribution rule. The following are eligible designated beneficiaries: a beneficiary who is disabled, a beneficiary who is chronically ill, certain trusts, a beneficiary who is not more than 10 years younger than you and your child who has not reached the age of majority. Once the child reaches the age of majority, she or he will have 10 years in which to close the inherited Roth IRA. As long as the 5-year Roth IRA taxation rule has been met by either you or your beneficiary, a distribution to your beneficiary is tax-free.

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.

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