A Roth individual retirement account (IRA) is a tax-deferred and potentially tax-free savings plan available to all working individuals and their spouses who meet the income requirements. An individual with a modified adjusted gross income (MAGI) of $125,000 ($127,000 in 2013) or more, or a married couple with a MAGI of $183,000 ($188,000 in 2013) or more will not be able to make any new contributions to their Roth IRA. Distributions, including accumulated earnings, may be tax-free if the account has been open at least five years and the individual is at least age 59½, or disabled, or has died. The opportunity to have a Roth IRA expanded, through a technique called a conversion, to include anyone who has an existing IRA and potentially most taxpayers who have earned income.

1 What is a Roth conversion?

When an IRA account owner decides to move all or part of his/her traditional IRA to a Roth IRA, it is called a conversion. Some or all of the traditional IRA's value is subject to income tax. Had the conversion been completed before 2010, the individual effectuating the conversion would have had to income-qualify to complete the transaction. (Please see Q&A 2.) An individual also may rollover a qualified plan account and convert it into a Roth IRA directly without opening a traditional IRA account.

The individual must maintain the Roth IRA account until the later of age 59½ or five years to have all the proceeds become income-tax free. (Please see Q&A 12 regarding the taxation ordering rules should a withdrawal occur before that time.)

2 What were the adjusted gross income (AGI) requirements for being Roth conversion eligible before 2010?

Whether the individual is married or single, the limit was $100,000. There are no income restrictions after 2009.1

3 How is the taxable income allocated if the conversion of a traditional IRA to a Roth IRA occurred in 2010?

Unless the taxpayer elects otherwise, the taxable income generated by the conversion of a traditional IRA to a Roth IRA in 2010 is included ratably over the two-taxable-year period beginning in 2011, i.e., 50% is added to income in 2011 and 50% is added in 2012.2 The participant also could have chosen to accept all the income during 2010.
May individuals younger than 70½ complete the Roth conversion if they otherwise have no earned income?

Yes. There were only upper limits restricting conversions prior to 2010, so the ability to convert, if you had no earned income, is not new.

May individuals older than 70½ convert their traditional IRA to a Roth IRA?

Individuals older than 70½ may convert to a Roth IRA, provided no portion of the amount converted is a required minimum distribution (RMD) under Internal Revenue Code Section 401(a)(9). The RMDs would be paid before the conversion occurs. (Minimum distributions must be taken from traditional IRAs by April 1 following the year that a person turns 70½. A minimum distribution must be taken from the IRA in each subsequent year. Failure to take the RMD will result in a 50% penalty on the amount that was not distributed. (Mandatory distributions that represent deductible contributions and all earnings are taxed as ordinary income. Mandatory distributions based on nondeductible contributions are tax-free.)

Do rollovers affect an individual’s ability to convert a traditional IRA to a Roth IRA?

If an individual is considering moving an existing retirement plan account into a traditional IRA and there are aftertax dollars in the IRA, increasing the taxable portion of the traditional IRA will increase how much of the conversion is taxable. (Please see Q&A 9.)

If there are no aftertax dollars in the traditional IRA, the question is moot, since all dollars converted are taxable; it then becomes an economic decision as to whether or not an individual can comfortably pay the taxes needed to maximize the conversion amount.

An individual might also consider, if there are aftertax dollars in his/her traditional IRA, rolling some or all of the traditional IRA assets to a 401(k) plan, for example, to create a greater concentration of nontaxable IRA assets within the traditional IRA before converting. The assets rolled into the qualified plan to achieve a greater concentration of nontaxable assets would need to remain in the rollover retirement plan account until at least the beginning of the calendar year following the conversion or the advantage is lost. (Please see Q&A 9.)

Are partial Roth conversions allowed?

Yes. The account owner may convert some or all of his/her IRA assets.

Can an individual pick which IRA he or she converts to a Roth?

Yes. However, the sum of all an individual’s IRAs (e.g., contributory, rollover, SEP, and SIMPLE) has to be considered to determine how much of the conversion is taxable. This only comes into play if an individual has aftertax dollars in an IRA. When there is no aftertax money in the IRA, the entire conversion is taxable. (Please see Q&A 9.)

If an individual does not do a full conversion and aftertax dollars are in the existing traditional IRA(s), how is the taxable amount of the conversion determined?

The nontaxable amount is determined by taking the amount converted and multiplying it by a fraction. The numerator of the fraction is the total aftertax dollars in all of an individual’s existing non-Roth IRAs and the denominator is the non-Roth IRAs account value at year-end plus the converted amount. The balance of the conversion is taxable.

(continued)
Assume a hypothetical participant, Sally, has IRA accounts totaling $80,000 at the end of 2012, the year the conversion occurred, and her IRAs contained $10,000 of aftertax dollars. She converted $20,000. However, Sally (more likely her accountant) must complete a calculation to determine basis recovery (i.e., how much of her conversion is income tax-free). The calculation will look something like this:

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Sally’s Roth conversion amount</td>
<td>$20,000</td>
</tr>
<tr>
<td>2.</td>
<td>Sally’s IRA basis</td>
<td>$10,000</td>
</tr>
<tr>
<td>3.</td>
<td>Sally’s remaining IRA value on December 31, 2012</td>
<td>$80,000</td>
</tr>
<tr>
<td>4.</td>
<td>Add amount converted to December 31, 2012, IRA value (1) + (3)</td>
<td>$100,000</td>
</tr>
<tr>
<td>5.</td>
<td>Tax-free conversion percentage (2) ÷ (4)</td>
<td>10%</td>
</tr>
<tr>
<td>6.</td>
<td>Tax-free conversion amount (5) x (1)</td>
<td>$2,000</td>
</tr>
<tr>
<td>7.</td>
<td>Taxable conversion amount (1) – (6)</td>
<td>$18,000</td>
</tr>
<tr>
<td>8.</td>
<td>Estimated tax on taxable conversion (7) @ 25%</td>
<td>$4,500</td>
</tr>
</tbody>
</table>

Sally will pay taxes on $18,000 of her $20,000 conversion, while $2,000 is tax-free. Since this conversion is after 2010, the entire taxable amount is added to Sally’s 2012 income tax return.

**Does the addition of the converted amount (taxable) to one’s income affect his/her eligibility to make a contributory Roth contribution?**

No. Income limits for new Roth contributions are still in effect. To some extent, even if one is not eligible to make a contributory Roth contribution, the individual could contribute to a traditional IRA and immediately convert the contribution to a Roth IRA. An individual must be younger than 70½ to do this (contribute to a traditional IRA), since traditional IRA contributions cannot be made after attaining age 70½.

However, this additional income is part of AGI for all other income taxes, so it could affect whether or not current (not future) Social Security benefits are taxable, the level of the premium payable under Medicare Part B (if you are a current Medicare participant), or whether or not additional taxes may be payable as a result of your being subject to alternative minimum tax (AMT).4

**Does the conversion of either spouse affect the taxation of the other’s IRA?**

No. These are individual retirement accounts. However, if the spouses are filing jointly, there could be a tax liability as a result of a converted IRA. If, for example, John Doe converts and Jane Doe does not, Jane’s IRA is not affected in any way by John’s conversion, but the taxable amount of the conversion gets added to their joint tax return.

**What are the withdrawal ordering rules when an individual converts his/her traditional IRA to a Roth IRA and subsequently makes a withdrawal?**

An individual must treat all his/her Roth IRA accounts as if there was one big Roth IRA. Therefore, if an individual set up a contributory Roth IRA in the past the first dollars withdrawn, regardless from which Roth account the money came, are considered contributory dollars and can be taken without tax consequence regardless of age or how long the account(s) has/have been open.

The next dollars withdrawn are considered converted dollars. When an individual converts a traditional IRA to a Roth IRA and withdraws any converted taxable amounts within the first five years following the conversion, the 10% penalty tax is applicable if the individual is younger than 59½ at the time of the distribution.5

The five-year period applies separately to each converted amount, with regard to whether the 10% penalty applies if there is a withdrawal, and includes the year of the conversion. For example, if a taxable conversion occurs anytime in 2013, the five-year period ends at the end of 2017.

(continued)
Any dollars withdrawn representing a gain, prior to attaining age 59½ and five years are subject to taxes, including the 10% penalty. If the gain is withdrawn after age 59½ but before five years, the gain is taxable, but the penalty does not apply. Five years is measured from the time the individual open his/her first Roth IRA account and that five-year period then applies to all his/her Roth accounts.

**Here’s a hypothetical example:**

Chris is 35 years old and converts a fully taxable $25,000 IRA in 2013. If Chris makes any withdrawals before January 1, 2018, the first $25,000 withdrawn is not subject to income taxation, but is subject to a 10% penalty tax. After December 31, 2017, Chris may withdraw up to $25,000, assuming no prior withdrawals were made, without any tax consequences. Any withdrawals above $25,000 are fully taxable and subject to a 10% penalty until Chris reaches age 59½.

If Chris converted at age 57 and already had a five-year-old Roth IRA, Chris need only wait until age 59½ arrives to have the ability to fully withdraw all the proceeds, including earnings penalty-tax free.

**What’s the deal with estimated taxes?**

If an individual converts a traditional IRA to a Roth IRA, it generally produces taxable income that gets added onto an individual’s tax return. If an individual does not have sufficient tax withholding to cover the potential tax payment, he/she should discuss the matter with their tax professional to determine whether some additional taxes should be prepaid. In general, this prepayment of taxes is completed by sending the Treasury an estimated tax payment. (Form 1040-ES is used for this purpose.) Depending on where the individual lives, a prepayment of state income taxes also may be necessary. (States have estimated tax forms similar to federal form 1040-ES.)

**What happens if an individual wants to make the conversion after 2010?**

If the conversion to a Roth IRA occurs after 2010, any income generated as a result of the conversion will be added to the individual’s income in the year of the conversion. The year 2010 is the only year in which income and subsequently the tax payments on that income could have been spread over two years. (See Q&A 9.)

**Can someone in 2010 or later who does not have a traditional IRA, and is ineligible to contribute to a Roth IRA, make a single contribution to a traditional IRA and immediately convert it to a Roth?**

The way we read the rules, this can be done. (Remember, an individual cannot just establish a single after-tax IRA and then cherry-pick the tax consequences if other traditional IRAs exist. Please see Q&A 9.) The traditional IRA account would need to be opened and funded. Then, Roth conversion paperwork would need to be completed and the funds transferred over.

**Can a Roth conversion be accomplished if an individual is receiving a series of substantially equal payments within the meaning of IRC Section 72(t)?**

If the traditional IRA accountholder is receiving a series of substantially equal payments within the meaning of IRC Section 72(t)(2)(A)(iv), the individual may convert the account to a Roth IRA while continuing to take the required payments without creating a modification that would cause potential adverse tax consequences.6

(continued)
What rights does a beneficiary have regarding converting an inherited account to a Roth IRA?

A beneficiary cannot convert an already established decedent (beneficial, inherited) IRA account or any IRA that he/she may come to inherit unless he/she is the spouse of the IRA account holder. However, a beneficiary may convert a decedent’s retirement plan account by transferring the account directly to a Roth IRA. Taxes are due in the year the conversion takes place. The money must move via a transfer directly from the qualified plan (e.g., 401(k), profit sharing, 403(b), 457(b) governmental, defined benefit, cash balance) to the newly established inherited Roth IRA. Distributions, based on the beneficiary’s life expectancy, must be made from the newly established inherited Roth IRA (the account cannot be commingled with any other of the beneficiary’s IRA accounts) by December 31 of the calendar year following the retirement plan participant’s death. If payments do not begin, the entire inherited Roth IRA would need to be distributed by the end of the fifth year following the retirement plan participant’s death.

Is there an ideal time to convert a traditional IRA to a Roth IRA?

It would seem that it might be better to convert the account earlier in a calendar year rather than later. If the assets grow post-conversion and the converted shares appreciate in value, no taxes are paid on the increase. If the same appreciated shares are converted later in the year, the tax liability would be greater.

If the shares converted early in the year lose value, an individual may recharacterize his/her new Roth account as a traditional IRA and, thus, in effect it never happened, thereby eliminating paying higher taxes on depreciated assets.

An individual may then reconvert in the calendar year following the original conversion, as long as 30 days have passed since the recharacterization. If the assets remain depressed, a tax gain could be realized by converting the same number of shares at a lower market value. This can be done only once with each separately converted and recharacterized IRA.

Here’s a hypothetical example:

Jesse converts a $10,000 traditional IRA on January 5, 2013. By August 31, 2013, its hypothetical value grows to $13,000. Had Jesse waited to convert the IRA until August, a full conversion would have had Jesse pick up $13,000 of income versus $10,000.

If Jesse’s same hypothetical investment lost value and was worth $7,000 versus $10,000, Jesse would be in an ideal position to recharacterize the Roth IRA (up until October 15, 2014) as a traditional IRA and reconvert in 2014 if the account value remained low. (Please see Q&A 19.)

Are there advantages to establishing a separate Roth IRA for each investment made?

If an individual converts his/her traditional IRA to a Roth IRA and establishes one Roth conversion account, a decision to recharacterize the investment as a traditional IRA, as a result of subpar performance, requires the individual to attribute the investment performance to the whole account.

However, if the individual opens up separate Roth IRA accounts for each asset class (e.g., domestic equity and corporate bonds funds), he/she can recharacterize only one instead of two investments as traditional IRAs, in this hypothetical example, if performance does not meet the individual’s expectations. This way, a fund that is performing well remains a Roth IRA and underachieving IRAs are recharacterized (and perhaps reconverted), saving the individual more tax dollars than he/she would have saved had all the funds been in one Roth IRA account, recharacterized, and then reconverted.

(continued)
How does the tax reporting work on Roth conversions?

If an individual is converting a traditional IRA, including a SEP, SIMPLE, or rollover, he/she will receive a 1099R from the individual’s IRA custodian indicating the amount of the conversion, though it says distribution in Box 1. Box 2a will indicate the taxable amount if known to the custodian or Box 2b, taxable amount undetermined, will be checked. Either distribution code 2, if the individual is under age 59½, or code 7, if the individual is age 59½ or older, will appear in Box 7.

If there are no aftertax dollars in any of the individual’s IRAs, he/she should complete the requests for personal information and Part II of Form 8606. If there are aftertax dollars in any of the individual’s IRAs, he/she also needs to complete Part I of Form 8606.

The taxable amount of the individual’s conversion on line 18 of Form 8606 determines what gets filled in on line 15b of Form 1040, line 11b of Form 1040A, and line 16b of Form 1040NR (depending on which form the individual is required to file) and the 8606 is attached to his/her return.

A rollover from a qualified plan to a Roth IRA is not a tax-free distribution other than any aftertax contributions an individual has made. Report a rollover from a qualified retirement plan to a Roth IRA on Form 1040, lines 16a and 16b; Form 1040A, lines 12a and 12b; or Form 1040NR, lines 17a and 17b (depending on which form an individual is required to file). He/she also will receive a Form 1099R from the qualified plan indicating the total and taxable distribution. The individual does not need to complete Form 8606.

What if Form 8606 was not filed in prior years recording the amount of after-tax dollars made to all of your IRAs?

If no Form 8606 was filed you should file Form 1040X for each tax year involved. You only need to complete the personal information at the top of the form, Items A and B under the personal information, and Part II where you explain what you are doing, attach the appropriate Form 8606 and sign both the 1040X and 8606.

Item A asks you to whether the address shown is different from the address shown on your last return filed with the IRS. Answering “yes” or not answering at all will cause the IRS to change your address to that listed on this form. Answering “no” will hold whatever is currently in the IRS system.

Item B asks for your filing status on the original return and on this return. Generally your status will be the same on this return (if you are filing only for this purpose) as it was on the original return. For those who were recently married or divorced, please verify your status before filing.

Are there any penalties involved?

Form 8606’s instructions state unless you can show reasonable cause, there is a $50 penalty for each year that you did not file.

Is it worthwhile to amend the return and pay the penalty?

Whether you are converting your IRA to a Roth IRA or not, if the IRS does not have a record of the nondeductible dollars contributed to your IRAs you may potentially pay tax again on those dollars when withdrawn.

What if I do not have copies of my prior tax returns?

If you do not have your prior tax returns you can request copies from the IRS. You would file Form 4506 and the IRS will send you a copy. You may request up to eight years of forms per Form 4506; there is a fee of $57 per return provided by the IRS. If you requested three returns with your 4506 filing, then you would attach a $171 check. The IRS will not process your request without a check.

If after you receive your copies, no Form 8606 was attached, then you must also file an amended return as described above and pay any appropriate penalties for not filing Form 8606.
Is there another way to obtain information from the IRS without paying fees?
To avoid the $57 per year fee, you can file Form 4506T. This service is free, and gets you a transcript of your filed 1040, plus it allows you to request a transcript of Form 5498. This form summarizes your IRA contributions, and is helpful if the amount you contributed on a yearly basis is unknown. Coordinating the 5498 information and your return information should allow you to determine whether or not you deducted any/all of your IRA contributions. Form 5498 information could also be requested from your IRA’s custodian(s). This could be more difficult if you moved your IRA from one financial institution to another and if any significant time has passed. In addition, financial institutions do not track whether your IRA contributions were pretax or aftertax.

Who should consider a Roth conversion?
- Individuals who have made significant aftertax contributions to their IRA so that the potential tax consequences are minimal.
- Individuals who can afford to pay the taxes using assets outside the traditional IRA. Using traditional IRA assets to pay the taxes can result in a 10% penalty if the individual is younger than 59½ at the time of the conversion.
- Individuals who believe that future tax rates will be greater than they are today.
- Individuals who wish to leave a potential tax free legacy to a non-spouse beneficiary. The account owner (or spouse if he/she inherits the account) is not required to take required minimum distributions from the account while alive. Individuals inheriting a Roth IRA are required to take annual distributions from the account based on their life expectancy, but the distributions are generally tax-free. A younger beneficiary could potentially make tax-free withdrawals over decades.
- Younger taxpayers who can benefit from multiple years of tax-deferred compounding and ultimately potentially tax-free income.
- S-Corporation business owners who have traditional IRAs and losses in their corporation that can be passed through and deducted on their personal income tax return (1040). An S-Corporation owner can only deduct losses that are equal to or less than his/her basis (contributions) in the business that have not been previously deducted. Please consult your tax adviser to determine if you are eligible.
- Self-employed individuals, partners in partnerships and members in a Limited Liability Corporation (LLC) may also have loss operating losses that my offset income. This matter should be discussed with the tax adviser to determine eligibility.

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1. Treasury Regulation 1.408A-4, (Q & A 2).
3. Treasury Regulation 1.408A-4, (Q & A 6).
4. Treasury Regulation 1.408A-4, (Q & A 9).
5. Treasury Regulation 1.408A-6, (Q & A 5).
6. Treasury Regulation 1.408A-4, (Q & A 12).
7. Treasury Regulation 1.408A-4, (Q & A 1) and Internal Revenue Code Section 408(d)(3)(A) and 408(d)(3)(B).
8. When an individual converts his/her Traditional IRA to a Roth IRA, it is sometimes reversed (called a recharacterization). This reversal must be completed by the tax filing due date, including extensions (October 15, 2013, for the year 2012), for the calendar year it was completed. The recharacterization includes all earnings and losses. The individual may reconvert to a Roth conversion IRA in the next calendar year so long as the reconversion is at least 30 days after the reversal.
9. Per IRS Notice 98-4, Q&A I–2, a 25% penalty tax will be applied to a payment or distribution received from a SIMPLE IRA (and a Roth conversion is treated as a distribution) during the two-year period beginning on the date the individual first participated in any SIMPLE IRA maintained by the individual’s employer.
Important Information

Traditional IRA contributions plus earnings, interest, dividends, and capital gains may compound tax-deferred until you withdraw them as retirement income. Amounts withdrawn from traditional IRA plans are generally included as taxable income in the year received and may be subject to 10% federal tax penalties if withdrawn prior to age 59½, unless an exception applies.

Brian Dobbis, QPA, QKA, QPFC
Retirement Analyst, Private Wealth Group

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Mr. Dobbis is recognized by the American Society of Pension Professionals and Actuaries (ASPPA) as a Qualified 401(k) Administrator (QKA), a Qualified Plan Administrator (QPA), and a Qualified Plan Financial Consultant (QPFC). He earned a BA in communication from Rowan University, and also is a holder of the Series 6, Series 63, and Series 65 licenses.

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