ROTH IRA CONVERSION FREQUENTLY ASKED QUESTIONS

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A Roth IRA is a tax-deferred and potential tax-free retirement account available to all individuals, regardless of age, who meet certain income requirements.

An individual with modified adjusted gross income (MAGI) of $133,000 ($135,000 in 2018) or more, or a married couple with MAGI of $196,000 ($199,000 in 2018) or more, is ineligible to make contributions to a Roth IRA. Distributions, including accumulated earnings, may be tax-free if the account has been held at least five years and the individual is at least age 59½, or disabled, or has died. The opportunity to establish a Roth IRA has expanded, through a technique called a *conversion*, is open to anyone, regardless of income, who has an existing IRA.

1 What is a Roth conversion?

When an IRA account owner decides to move all or part of his/her traditional IRA (including SEP and SIMPLE IRAs) to a Roth IRA, it is called a *conversion*. Some or all of the funds converted to a Roth IRA are subject to current taxation. An individual also may roll over a qualified plan account (e.g., 401(k)) and convert it into a Roth IRA directly, without opening a traditional IRA account. This transaction too would be a taxable event. Conversion amounts that represent deductible contributions, and all earnings, are taxed as ordinary, income whereas (aftertax) funds based on nondeductible contributions are tax-free.

2 May individuals younger than 70½ complete the Roth conversion if they otherwise have no earned income?

Yes. Income is not required to be Roth IRA-conversion eligible.

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

Yes. Individuals older than 70½ may convert to a Roth IRA, provided that no portion of the funds converted are a required minimum distribution (RMD).[2] An RMD needs to be paid before the conversion occurs.

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

Potentially. If an individual is considering rolling over an existing workplace retirement plan account (e.g. 401(k)) into a traditional IRA and there are nondeductible (aftertax) dollars in the IRA, increasing the taxable portion of the traditional IRA will increase how much of the conversion is taxable. If there are no aftertax dollars in the traditional IRA, the question is moot, since all dollars converted are taxable.

5 Are partial Roth conversions allowed?

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

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

Yes. However, the total value of all an individual's IRAs (including: traditional, rollover, SEP, SAR SEP, and SIMPLE) has to be considered to determine how much of the conversion is taxable. This comes into play only if an individual has nondeductible (aftertax) dollars in any of their IRAs. When there is no aftertax money in the IRA, the entire conversion amount is taxable.

7 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?

When there are nondeductible (aftertax) funds in any IRA, the IRS "pro-rata" rule applies to all IRA distributions, including Roth conversions.

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.

Here's a hypothetical example:

Sally has IRA accounts totaling $80,000 at the end of 2017, the year the conversion occurred, and her IRAs contained $10,000 of aftertax dollars. She converted $20,000. However, Sally must complete a calculation to determine basis recovery (i.e., how much of her conversion is income tax–free).

The calculation will look like this:

1. Sally's Roth conversion amount	$20,000
2. Sally's IRA basis	$10,000
3. Sally's remaining IRA value on December 31, 2017	$80,000
4. Add amount converted to December 31, 2016, IRA value (1) + (3)	$100,000
5. Tax-free conversion percentage (2) ÷ (4)	10%
6. Tax-free conversion amount (5) x (1)	$2,000
7. Taxable conversion amount (1) – (6)	$18,000
8. Estimated tax on taxable conversion (7) @ 25%	$4,500

Sally will pay taxes on $18,000 of her $20,000 conversion, while $2,000 is recovered tax-free. The taxable amount is added to Sally's 2017 income tax return

8 Does the addition of the converted (taxable) amount to an individual's income affect his or her eligibility to make a Roth IRA contribution?

No. Increasing an individual's income (MAGI) due to a Roth conversion does not affect one's eligibility to make Roth IRA contributions. In other words, an individual whose income qualified prior to a conversion would remain eligible post conversion.[3]

9 Does the conversion of either spouse's IRA affect the taxation of the other's IRA?

No. However, if the spouses are filing jointly, there could be a tax liability as a result of a converted IRA. If, for example, John converts his IRA and Jane 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.

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

An individual must treat all his/her Roth IRA accounts as if they were one single Roth IRA. Therefore, if an individual previously established a contributory Roth IRA, the first dollars withdrawn, regardless of from which Roth account the money came, are considered contributory dollars and can be taken without being subject to tax or penalty, regardless of age or when the account(s) were established.

The next dollars withdrawn are considered converted dollars. When an individual converts a traditional IRA to a Roth IRA and subsequently 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.[3] The five-year hold period applies separately to each converted amount, with regard to whether the 10% penalty ("recapture tax") applies if there is a withdrawal, and includes the year of the conversion. For example, if a taxable conversion occurs anytime in 2017, the five-year period is satisfied as of January 2022.

Any dollars withdrawn representing a gain, before attaining age 59½ and five years, are subject to income 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 year period is measured from the time the individual funds his/her first Roth IRA account, and applies to all his/her Roth accounts.

Here's a hypothetical example:

Chris, 35, converts a fully taxable $25,000 traditional IRA in 2017. Should Chris withdraw any funds before January 1, 2022, the first $25,000 withdrawn is not subject to income taxation but is subject to a 10% penalty tax (known as a "recapture tax"). After December 31, 2021, Chris may withdraw up to $25,000, (assuming no prior withdrawals were made), without being subject to taxation or penalties. Any withdrawals above $25,000 are fully taxable and subject to a 10% penalty until Chris reaches age 59½.

11 Can an individual who is ineligible to contribute to a Roth IRA, make a single contribution to a traditional IRA and immediately convert it to a Roth ("back-door" Roth)?

The way we read the rules, this can be done. Although, an individual cannot just establish a separate nondeductible (aftertax) traditional IRA and then cherry-pick the tax result, if they already own other traditional IRAs (including SEP, SIMPLE, and rollover IRAs). (See Q&A 8.)

12 Can an individual receiving a series of substantially equal periodic payments under Section 72(t) convert to a Roth IRA?

Yes. If the traditional IRA accountholder is receiving a series of substantially equal periodic payments under Section 72(t), the individual may convert the account to a Roth IRA, while continuing to take the required payments without creating a modification causing potential adverse tax consequences.

13 What rights does a beneficiary have regarding converting an inherited IRA to a Roth IRA?

A beneficiary cannot convert an inherited IRA (traditional, SEP or SIMPLE) unless he/she is the surviving spouse of the IRA accountholder.[2]

However, a non-spouse beneficiary may convert a decedent's workplace retirement plan (e.g., 401 (k)) by transferring the account *directly* to a Roth IRA. Taxes are due in the year the conversion takes place. Funds must move via a direct transfer from the qualified plan to the newly established inherited Roth IRA.

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

One school of thought is to convert early in the calendar year. Should the account value increase post-conversion, no taxes are due on the growth. Whereas 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 reverse the conversion via a technique known as recharacterization.[2] A rechacterization in effect erases the conversion, as though it never happened, thereby eliminating higher taxes on depreciated assets.

An individual may then reconvert in the calendar year following the original conversion, as long as more than 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.

Here's a hypothetical example:

Jesse converts a $10,000 traditional IRA on January 5, 2017. By August 31, 2017, the value has increased to $13,000. Had Jesse waited until August to convert the IRA, a full conversion would have had Jesse pick up an additional $3,000 of income.

If Jesse's same investment lost value and was worth $7,000 rather than $10,000, Jesse would be in an ideal position to recharacterize the Roth IRA (up until October 15, 2018) as a traditional IRA and reconvert in 2017 if the account value remained depressed.

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

Potentially. 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 establishes separate Roth IRA accounts for each underlying investment, he/she can recharacterize only one instead of two investments as traditional IRAs, if performance does not meet the individual's expectations. This way, an investment that is performing well remains a Roth IRA, while underachievers are recharacterized (and perhaps reconverted), saving the individual more tax dollars than he/she would have saved had all the investments been contained in one single Roth IRA account.

For additional information on recharacterization see our article "How to Get a "Do-Over" on Your Roth IRA."

16 What if IRS Form 8606 was not filed in prior years recording the amount of aftertax dollars made to all your IRAs?

Form 8606 "Nondeductible IRAs" tracks an investor's IRA basis. The account holder is responsible for tracking all their nondeductible contributions.

For additional information on reporting IRA basis see here.

17 Are there any penalties involved for failing to file Form 8606?

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

18 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 (or your beneficiaries) may potentially pay tax again on those dollars when withdrawn.

19 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.
- 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 deduct only those losses that are equal to or less than his/her basis (contributions) in the business and that have not been previously deducted. Please consult with your tax advisor to determine whether you are eligible.
- Self-employed individuals, partners in partnerships, and members in a limited liability corporation (LLC) may also have net operating losses that may offset income. This matter should be discussed with the tax advisor to determine eligibility.

22 What Resources does Lord Abbett offer?

We offer a number of Roth IRA and conversion resources including:

- "Should I Convert to a Roth IRA" calculator
- Roth IRA Overview webpage
- Roth IRA application
- Roth IRA Conversion form

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 before age 59½, unless an exception applies.

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Brian Dobbis is responsible for managing Lord Abbett's IRA business. His areas of expertise include IRAs, 401(k), 403(b), and 457 retirement plans.

Mr. Dobbis joined Lord Abbett in 2002, and held the positions of Retirement Consultant and Retirement Research Associate. He began his career in the financial services industry in 1997.

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[1] Tax Increase Prevention and Reconciliation Act of 2005 (Section 512), (Q & A 2).

[2] Treasury Regulation 1.408A-4, (Q & A 4, 15, 16).

[3] Treasury Regulation 1.408A-4, (Q & A 11).

FOR MORE INFORMATION:
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