

CPA Continuing Education
Society of PA
Russell Valante
President
Madison Bank Building
1767 Sentry Parkway West
Blue Bell, PA 19422
215.619.3920
rvalante@jmsonline.com
www.cpasocietypa.org

Converting or Rolling Over Traditional IRAs to Roth IRAs

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What is it?

Depending upon your annual income and federal income tax filing status, you may be able to transfer all or a portion of your traditional IRA funds to a Roth IRA. This can be accomplished in one of two ways: You can convert your traditional IRA to a Roth IRA, or you can roll over funds from your traditional IRA to a Roth IRA.

In the case of a conversion, you notify the trustee or custodian of your traditional IRA that you wish to convert your traditional IRA to a Roth IRA. The account is then renamed as a Roth IRA, and your funds never actually leave the account. In the case of a rollover, you actually transfer the funds from your traditional IRA to a Roth IRA. The income tax consequences of the two methods are identical.

The fact that you qualify to convert or roll over funds from your traditional IRA to a Roth IRA doesn't necessarily mean that you should. There are a number of factors that you need to consider.

Tip: Starting in 2006, employers may allow employees to make after-tax "Roth" contributions to 401(k) and 403(b) plans. Qualified distributions of these contributions and related earnings may be income tax free (and penalty free) at the federal level. This may be a factor in your decision of whether to convert funds from a traditional IRA to a Roth IRA. However, be sure to discuss your situation with a qualified professional before making any decisions. For more information, see Roth 401(k).

When can it be used?

You have a traditional IRA

It probably goes without saying, but you can't convert or roll over funds from a traditional IRA to a Roth IRA unless you already have a traditional IRA.

Tip: In addition to traditional IRAs, SEP-IRAs, SAR-SEP IRAs, and SIMPLE IRAs (those that have existed for at least two years) are eligible to be converted to a Roth IRA. Further, a rollover IRA (i.e., a traditional IRA containing funds rolled over from an employer-sponsored plan) is also eligible to be converted to a Roth IRA. The rules that apply to conversions from traditional IRAs, as discussed in this article, also apply to SEP, SAR-SEP, and SIMPLE conversions.

Your modified adjusted gross income is less than or equal to \$100,000

If you have funds in a traditional IRA, you can convert or roll over all or a portion of those funds to a Roth IRA if you file your federal income tax return as a single taxpayer and if your modified adjusted gross income (MAGI) for the year is less than or equal to \$100,000. If you're married and file your return as married filing jointly, the combined MAGI of you and your spouse for the year must be less than or equal to \$100,000. Amounts that must be included in your taxable income as a result of conversion or rollover to a Roth IRA are not considered when determining if your annual income exceeds this \$100,000 threshold.

Tip: If you want to convert or roll over funds from a traditional IRA to a Roth IRA, but your MAGI for the year is over the \$100,000 threshold, consider methods of deferring income to bring your income for the year below the threshold. Another tip: If your annual income is close to the \$100,000 threshold, it might be better to wait until the end of the year to make sure you will qualify. Unexpected income in the form of a year-end bonus or lottery winnings could push you over the \$100,000 threshold.

Tip: The Tax Increase Prevention and Reconciliation Act of 2005 eliminates the \$100,000 ceiling for converting a traditional IRA to a Roth IRA for tax years after 2009.

You do not file your federal income tax return as married filing separately

If your federal income tax filing status for the year is married filing separately, you cannot convert or roll over funds from a traditional IRA to a Roth IRA for that year. However, if you and your spouse file separate federal returns and lived apart at all times during the tax year, you are treated as a single taxpayer for purposes of determining your eligibility to convert or roll over funds.

Tip: For tax years after 2009, married individuals who file separate returns will be able to convert funds from a traditional IRA to a Roth IRA.

Rollovers must follow IRA rollover rules

As mentioned, one of the two ways to transfer funds from a traditional IRA to a Roth IRA is to withdraw the funds from your traditional IRA, and then roll those funds over into a Roth IRA in your name. If you choose this method to transfer funds, you must comply with federal rules governing IRA rollovers. For example, if you roll over funds from a traditional IRA to a Roth IRA, the funds must be deposited in the Roth IRA within 60 days after you receive the distribution from the traditional IRA. If you do not meet the 60-day deadline, you may be subject to tax consequences and a penalty. There is no limit on the number of rollovers from traditional IRAs to Roth IRAs that you can do in a year.

Tip: The 60-day deadline can be waived in certain circumstances. You may be eligible for an automatic waiver if you sent your rollover assets to a financial institution within the 60-day period, but the financial institution makes an error and fails to complete your rollover before the deadline. However, to be eligible to use this automatic waiver, your rollover must be completed within one year from the beginning of the 60-day period. The IRS also has the discretion to grant a waiver of the 60-day deadline in certain circumstances.

Strengths

Qualified distributions from Roth IRAs are tax free

A withdrawal from a Roth IRA (including both contributions and investment earnings) is completely tax free (and penalty free) if made at least five years after you first establish any Roth IRA, and if one of the following applies:

- You have reached age 59½ at the time of the withdrawal
- The withdrawal was made due to qualifying disability
- The withdrawal was made to pay for first-time homebuyer expenses (\$10,000 lifetime limit)
- The withdrawal is made by your beneficiary or estate after your death

Tip: The five-year holding period begins on January 1 of the tax year in which you make your first contribution to any Roth IRA. Each taxpayer has only one five-year holding period for this purpose.

If none of these conditions is met, only the portion of a Roth IRA withdrawal that represents investment earnings will be subject to federal income tax. The portion of a Roth IRA withdrawal that represents your contributions (including amounts converted to or rolled over from a traditional IRA) is never taxable, since those dollars were already taxed. Roth IRA withdrawals are treated as coming from your contributions first and investment earnings last. For more information, see Roth IRAs.

Caution: If you convert or roll over funds from a traditional IRA to a Roth IRA, special penalty provisions may apply if you subsequently withdraw funds from the Roth IRA within five years of the conversion (and prior to age 59½).

Roth IRAs are not subject to the lifetime required minimum distribution (RMD) rules

Federal law requires you to take annual minimum withdrawals (required minimum distributions, or RMDs) from your traditional IRAs beginning no later than April 1 of the year following the year in which you reach age 70½. These withdrawals are calculated to dispose of all of the money in the traditional IRA over a given period of time. Because Roth IRAs are not subject to the lifetime RMD rules, you are not required to make any withdrawals from your Roth IRAs during your life. This can be a significant advantage in terms of your estate planning and may be a good reason to consider converting funds.

Converting or rolling over funds may reduce your taxable estate and your countable assets

If you use non-IRA funds to pay the conversion tax that results from converting or rolling over funds from a traditional IRA to a Roth IRA, the funds that you use to pay the tax are removed from your taxable estate, potentially reducing your future estate tax liability. Also, the funds that you use to pay the tax are no longer part of your countable assets for purposes of determining your children's eligibility for financial aid. In contrast, if you use IRA funds to pay the conversion tax, there generally is no effect on financial aid eligibility.

Qualified distributions from Roth IRAs are not included when determining the taxable portion of Social Security benefits

Converting or rolling over your funds from a traditional IRA to a Roth IRA could be beneficial when it comes time to begin receiving your Social Security benefits. The portion of your Social Security benefits that is taxable (if any) depends on your MAGI and federal income tax filing status in a given year. Under current law, qualified distributions from Roth IRAs are not included when determining the taxable portion of an individual's Social Security benefits. However, some people believe that the law may eventually change to include qualified distributions from Roth IRAs in this calculation.

Tradeoffs

You have to pay tax now on the funds that you convert or roll over

When you convert or roll over funds from a traditional IRA to a Roth IRA, the funds that you transfer are subject to federal income tax (to the extent that those funds represent investment earnings and tax-deductible contributions made to the traditional IRA). Even if it makes overall financial sense to convert funds from a traditional IRA to a Roth IRA, paying tax on your IRA funds now may not be desirable.

Tip: Special rules apply to conversions made in 2010. The amount that must be included in income as a result of the conversion will be able to be averaged over the next two years. That is, no resulting income need be reported on the individual's 2010 tax return. Instead, half of the income may be reported in 2011, and the remaining half in 2012.

Using IRA funds to pay conversion tax has significant drawbacks

If using other IRA dollars is the only way that you can pay the conversion tax that results from converting or rolling over funds from a traditional IRA to a Roth IRA, the benefits of converting or rolling over funds are substantially reduced. Using IRA dollars to pay the tax reduces the amount of funds in your IRAs, potentially jeopardizing your retirement goals. In addition, the IRA funds used to pay the tax may themselves be subject to federal income tax and a premature distribution tax. If possible, paying the conversion tax with non-IRA funds is generally more advisable.

Special penalty provisions may apply to withdrawals from Roth IRAs that contain funds converted from traditional IRAs

If you're under age 59½ and take a nonqualified distribution from a Roth IRA, the 10 percent premature distribution tax generally applies only to that portion of the distribution that represents investment earnings. However, if you convert or roll over funds from a traditional IRA to a Roth IRA and then take a premature distribution from that Roth IRA within five years, the 10 percent premature distribution tax will apply to the entire

amount of the distribution (to the extent that the distribution consists of funds that were taxed at the time of conversion). See *Premature Distribution Rules* for exceptions to the 10 percent penalty tax.

Tip: The five-year holding period begins on January 1 of the tax year in which you converted or rolled over the funds from the traditional IRA to the Roth IRA. When applying this special rule, a separate five-year holding period applies each time you convert or roll over funds from a traditional IRA to a Roth IRA.

Taxable income resulting from conversion can increase taxable portion of Social Security benefits being received

If you're currently receiving Social Security benefits or soon will be, consider the possible tax consequences of converting or rolling over funds from a traditional IRA to a Roth IRA. When you convert or roll over funds, those funds are generally considered taxable income to you for the year in which you transfer them. Remember that the portion of your Social Security benefits that is taxable (if any) depends on your income and tax filing status for the year. This means that converting funds to a Roth IRA may increase the taxable portion of your Social Security benefits for that year.

Risk of future change in the law

One of the main reasons to consider converting or rolling over funds from a traditional IRA to a Roth IRA is that qualified distributions from Roth IRAs are completely tax free. Under current law, this is the federal tax treatment given to Roth IRAs. Some experts, however, are skeptical that this will always remain the case, given the uncertain status of Social Security and the projected lost federal revenue attributable to Roth IRAs.

States may differ in their treatment of Roth IRAs

Although most states follow the federal tax treatment of Roth IRAs, you should check with a tax professional regarding the tax treatment of Roth IRAs in your particular state.

Creditor protection

Federal law provides protection for up to \$1,095,000 (as of 4/1/07) of your aggregate Roth and traditional IRA assets if you declare bankruptcy. (Amounts rolled over to the IRA from an employer qualified plan or 403(b) plan, plus any earnings on the rollover, aren't subject to this dollar cap and are fully protected.) The laws of your particular state may provide additional bankruptcy protection, and may provide protection from the claims of your creditors in cases outside of bankruptcy. In some states the creditor protection available to Roth IRAs may be less than that available to traditional IRAs.

How to do it

Calculate the tax that will result from converting or rolling over funds from your traditional IRAs to Roth IRAs

All or a portion of the funds that you convert or roll over from your traditional IRA to a Roth IRA will be subject to federal income tax in the year that you shift the funds. Consult a tax professional for an accurate calculation of the income tax liability that will result. This will help you decide if converting funds makes sense for you.

Decide where the dollars will come from to pay the resulting tax

Decide if you will use IRA funds or non-IRA funds to pay the conversion tax that will result from converting or rolling over funds, and make sure that you understand the tax consequences of either choice. For example, if you plan to sell stock to pay the tax, realize that your sale of stock will have tax consequences of its own. If you plan to use IRA funds to pay the tax, be aware that this may trigger additional income tax liability (and possibly a penalty). Again, consult a tax professional.

Decide whether to convert or roll over

If you have decided to transfer funds from your traditional IRA to a Roth IRA, your next step is to decide whether to convert your traditional IRA to a Roth IRA, or to roll over your traditional IRA funds to a Roth IRA. The income tax consequences are the same either way, so the question is: Do you want your IRA to stay at the same institution with the same custodian/trustee, or would you prefer to move your IRA dollars to another institution and have a different custodian/trustee?

If converting, contact the custodian of your traditional IRA

The custodian/trustee of your traditional IRA will provide you the paperwork you need to convert your traditional IRA to a Roth IRA with that same institution.

If rolling over, establish a Roth IRA and roll over your traditional IRA

First, you need to establish a Roth IRA in your name, if you don't already have one. Once you have a Roth IRA, you can have the funds in your traditional IRA transferred directly to your Roth IRA. The custodian of your Roth IRA can give you the paperwork that you need to do this. If you prefer, you can instead contact the custodian of your traditional IRA, have the funds in your traditional IRA distributed to you, and then roll those funds over into your Roth IRA within 60 days of the distribution.

Tax considerations

You include funds that are converted or rolled over from a traditional IRA to a Roth IRA in income

When you convert or roll over funds from a traditional IRA to a Roth IRA, those funds are subject to federal income tax in the year that you transfer them (to the extent that the funds consist of deductible contributions and investment earnings). If you have made only deductible contributions to your traditional IRAs, then the entire amount of any funds that you convert or roll over to a Roth IRA will be taxable. If, however, you have ever made nondeductible (after-tax) contributions to your traditional IRAs, then those contribution amounts will not be taxable when converted or rolled over to a Roth IRA (since they have already been taxed). In effect, the income tax consequences of converting funds are the same as those that apply when you make a withdrawal from a traditional IRA.

Tip: Amounts that must be included in your taxable income as a result of converting funds from a traditional IRA to a Roth IRA are not considered when determining if you qualify to convert funds in the first place.

Application of the 10 percent premature distribution tax

The 10 percent premature distribution tax does not apply at the time that you convert or roll over funds from a traditional IRA to a Roth IRA, even if you convert the funds before reaching age 59½. However, if you convert or roll over funds from a traditional IRA to a Roth IRA and withdraw any portion of those funds from the Roth IRA within five years (and prior to age 59½), the withdrawal will be subject to the 10 percent premature distribution tax (to the extent those funds were taxed at the time of the conversion). See *Premature Distribution Rules* for exceptions to the 10 percent early distribution penalty.

Caution: Remember that withdrawals from Roth IRAs are treated as coming from contributions first and investment earnings second. Contributions are considered to consist first of regular contributions (i.e., contributions other than rollover contributions), and then of amounts converted or rolled over from a traditional IRA (on a first in, first out basis).

Tip: All of your Roth IRAs are aggregated for this purpose.

Example(s): John is age 40. John contributed \$3,000 to his Roth IRA in 2004. In 2005, John converted \$10,000 from his traditional IRA to his Roth IRA, and included this \$10,000 in his 2005 gross income. He made no further contributions to his Roth IRA. In 2007, his Roth IRA has grown to

\$14,000, of which John withdraws \$4,000. None of the exceptions to the 10 percent premature distribution tax apply to John. John's \$4,000 withdrawal is considered to consist first of his \$3,000 regular contribution made in 2004. John owes no premature distribution tax on this \$3,000. The remaining \$1,000 of John's \$4,000 withdrawal is considered to consist of funds he converted from his traditional IRA, and is subject to the 10 percent premature distribution tax.

You can't convert or roll over RMDs into a Roth IRA

After age 70½, you are required to begin taking annual minimum withdrawals from your traditional IRAs (RMDs). You cannot roll over or convert these RMD amounts to a Roth IRA.

Special rules apply to conversions made in 2010

For Roth conversions made in 2010 only, the amount includible in gross income as a result of the conversion will be averaged over the following two years, unless the taxpayer elects otherwise. That is, no resulting income will be reported on the individual's 2010 federal income tax return. Half the resulting income will be reported on the taxpayer's tax return for 2011, and the remaining half will be reported on the taxpayer's tax return for 2012.

Caution: Income inclusion will be accelerated if converted amounts are distributed before 2012. In that case, the amount included in income in the year of distribution is increased by the amount distributed, and the amount included in income in 2012 (or 2011 if the distribution takes place in 2010) is the lesser of: (1) half of the amount includible in income as a result of the conversion, and (2) the remaining portion of such amount not already included in income.

Example(s): [From Joint Explanatory Statement of the Committee of Conference] Taxpayer A has a traditional IRA with a value of \$100, consisting of deductible contributions and earnings. A does not have a Roth IRA. A converts the traditional IRA to a Roth IRA in 2010, and, as a result of the conversion, \$100 is includible in gross income. Unless A elects otherwise, \$50 of the income resulting from the conversion is included in income in 2011, and \$50 in 2012. Later in 2010, A takes a \$20 distribution, which is not a qualified distribution and all of which, under the ordering rules, is attributable to amounts includible in gross income as a result of the conversion. Under the accelerated inclusion rule, \$20 is included in income in 2010. The amount included in income in 2011 is the lesser of: (1) \$50 (half of the income resulting from the conversion), or (2) \$70 (the remaining income from the conversion), in other words -- \$50. The amount included in income in 2012 is the lesser of: (1) \$50 (half of the income resulting from the conversion), or (2) the remaining income from the conversion, i.e., \$100 - \$70 (\$20 included in income in 2010 and \$50 included in income in 2011), in other words -- \$30.

Questions & Answers

Should you convert or roll over funds from your traditional IRA to a Roth IRA?

Before you even begin to think about converting or rolling over funds from a traditional IRA to a Roth IRA, be sure that you understand what the Roth IRA is and how it works. If the Roth IRA seems like an appropriate retirement savings vehicle, make sure that you qualify to convert funds from a traditional IRA to a Roth IRA. If you qualify, be sure to consider the income tax consequences of converting funds, and how you will pay the resulting tax. Think about the following scenarios and factors before you act.

Scenario 1: You don't qualify to convert funds because your MAGI for the year exceeds the \$100,000 threshold.

Scenario 2: You'll pay the resulting "conversion" tax with non-IRA funds, you have 10 years or more before you will be taking distributions from the Roth IRA, and you will be in the same or a higher tax bracket when you start taking those distributions. Converting funds probably makes overall sense.

Scenario 3: You'll pay the conversion tax with IRA funds, you need to take substantial distributions from the Roth IRA within a few years (5 years or less), and you will be under age 59½, or in a lower tax bracket when you begin taking distributions. You probably shouldn't convert funds to a Roth IRA.

Can you convert or roll over only a portion of the funds in your traditional IRAs to Roth IRAs?

Yes. If you qualify to convert funds, you can convert or roll over whatever amount you want from your traditional IRAs to a Roth IRA. All or a portion of the funds that you convert or roll over to the Roth IRA will be subject to federal income tax. If you have ever made nondeductible (after-tax) contributions to your traditional IRAs, you have to calculate what portion of the funds that you convert represents nondeductible contributions. Because those amounts were already taxed, they will not be taxed again when converted to a Roth IRA.

How do you calculate the portion of your conversion that represents nondeductible contributions?

If you have made only deductible contributions to your traditional IRAs, the full amount that you convert or roll over from your traditional IRAs to a Roth IRA will be subject to federal income tax, since no portion of the funds represents nondeductible contributions. If you have ever made nondeductible contributions to your traditional IRAs, you calculate and report the taxable and nontaxable portions of the funds that you convert or roll over using IRS Form 8606. Basically, you calculate the ratio of all of your nondeductible contributions to the total balance of all of your traditional IRAs, including simplified employee pension plan IRAs and savings incentive match plan for employees (SIMPLE) IRAs. That ratio is then applied to any withdrawal that you make from any of your traditional IRAs, including a conversion or rollover to a Roth IRA. So, if 50 percent of the total balance of all of your traditional IRAs represents nondeductible contributions, half of the funds that you convert to a Roth IRA would be taxable, and half would not.

Can you convert or roll over funds from your traditional IRAs to a Roth IRA if you're already receiving RMDs from your traditional IRAs?

Unlike traditional IRAs, you can contribute to a Roth IRA after age 70½, so the fact that you're receiving RMDs from your traditional IRAs doesn't by itself disqualify you from converting funds to a Roth IRA. You cannot, however, convert or roll over an RMD itself into a Roth IRA.

Tip: RMDs from traditional IRAs don't count in determining whether your MAGI for the year exceeds the \$100,000 threshold for converting funds to a Roth IRA.

Can you "undo" or recharacterize a traditional IRA to Roth IRA conversion?

You may be able to undo or recharacterize a Roth IRA conversion by making a trustee-to-trustee transfer of the contribution (plus any related earnings) from the Roth IRA back to the traditional IRA within certain deadlines. You may want to consider undoing a Roth conversion if your income for the year of the conversion ends up exceeding the Roth IRA eligibility limit. Additionally, if your IRA investments experience a significant decline after the conversion date, you may be able to minimize your tax hit by reversing (recharacterizing) your conversion. Generally, the deadline for recharacterizing an IRA contribution or Roth IRA conversion is the due date of your federal income tax return (including extensions) for the year of the original contribution. For more information, see Recharacterizing IRA Contributions and Roth Conversions.

When you withdraw funds from a Roth IRA, in what order are the funds considered withdrawn?

Withdrawals from Roth IRAs are considered made in the following order:

- Regular Roth IRA contributions (i.e., contributions other than rollover or conversion contributions).
- Rollover or conversion contributions, in the order made (i.e., first in, first out). If any rollover or conversion included nondeductible contributions, the withdrawal is considered made first from funds that were subject to federal income tax at the time of the rollover or conversion.
- Any investment earnings.

All Roth IRAs you maintain are aggregated (i.e., treated as a single Roth IRA) for purposes of classifying withdrawals.

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rvalante@jmsonline.com
www.cpasocietypa.org

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