Answers to Common Roth Conversion Questions

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When to convert, how to figure out taxes, why to undo a conversion, and more.

Four key points

1. Convert early or later in the year? There are pros and cons of each.
2. There are good reasons to consider undoing a conversion.
3. Tax liability depends on whether you're converting pretax or after-tax money.
4. Over age 70½? You need to take a required distribution the year you convert.

Who wouldn't want tax-free growth potential and withdrawals in retirement? That's what you can get with a Roth IRA. The problem is, not everyone can contribute to a one because of IRS-imposed income limits. But you still may be able to benefit from a Roth IRA's tax-free growth potential and tax-free withdrawals by converting existing money in a traditional IRA or other retirement savings account.[1] Here we answer some questions we often hear from would-be converters.

Does it matter when you convert?

There are potential benefits to converting either early or late in the year. That said, converting earlier generally gives you more flexibility than converting later. Consider the pros and cons.

Early in the year

- Taxes aren't due until April 15 of the following year, so you may have more than 16 months to pay the taxes on your converted balances. (Note: If you pay estimated taxes, you may need to make payments sooner.)
- If you change your mind, you have more time to act—until October 15 of the following year (the extended deadline for tax filing) to undo the conversion.

But... if you convert an amount early in the year and then undo the conversion within the same tax year, you'll have to wait until January 1 of the following year before you can reconvert those balances into a Roth IRA.

Later in the year

- The clock on the five-year rule for withdrawing earnings tax and penalty free from a Roth IRA begins in January of the year you convert—no matter when you actually convert. So a conversion made on

December 31, is considered the same as a conversion made on January 1 of the same year. Both are eligible for penalty-free earnings withdrawals beginning January 1 five years later, as long as at least one of the other IRS qualified earnings distribution triggers has been met: you reach age 59½, become disabled, make a qualified first-time home purchase, or die. So if you convert later in the year, you have the potential to access these funds almost a full year sooner than if you converted earlier in the year. (Note, however, that for tax purposes the five-year rule clock starts from the year you fund any Roth IRA. So if you already have a Roth IRA, the late conversion advantage doesn't apply.)

- You'll have more information about your income taxes for the year. This may allow you to convert a more targeted amount to ensure that the income from the conversion doesn't bump you into a higher income tax bracket. Because the amount you convert is considered taxable income (assuming there weren't any after-tax contributions), you may want to consider converting no more than what you think will bring you to the top of your current federal income tax bracket.
- Should you need to undo the conversion later in the year, you may have a shorter reconversion waiting period. For instance, if you convert in December, the waiting period, could be as little as 30 days after the recharacterization—the process of undoing a Roth IRA conversion.

But... assuming that you don't undo the conversion, taxes on the amount you converted will be due not long after your conversion.

Why would I want to consider undoing a conversion?

There may be good reasons to undo a Roth IRA conversion, put the assets back into a non-Roth IRA—such as a traditional IRA—and, if applicable, get a refund of taxes paid:

- Your taxable income ended up higher than you expected and/or the additional income from the Roth IRA conversion bumped you into a higher federal income tax bracket.
- You've determined that your taxable income in retirement will likely be lower than you expected, reducing the potential benefits of the tax-free distributions from a Roth IRA.
- The value of your investments in the converted Roth IRA declined. Undoing the conversion and then re-converting when eligible might result in a lower tax bill.
- You don't have enough cash on hand to pay the taxes.
- Any other reason, really. The IRS has no requirements on this front.

A recharacterization needs to be completed by the last date to file or refile your prior-year taxes, including extensions. This is typically on or about October 15. That's why the earlier in the year you convert, the longer you have to determine whether a recharacterization makes sense. You can generally recharacterize all or a portion of what you converted. If you want, assets that you recharacterize to a traditional IRA can be reconverted to a Roth IRA in the next tax year after the tax year you initially convert, or 30 days after the recharacterization, whichever is later.

Can I convert just part of my traditional IRA balances to a Roth IRA?

Yes, you can choose to convert as much or as little as you want of your eligible traditional IRAs. This flexibility enables you to manage the tax cost of your conversion.

For instance, because the amount you convert is generally considered taxable income, you may want to consider converting no more than what you think will bring you to the top of your current federal income tax bracket. You also may want to consider basing your conversion amount on the tax liability you may incur, so you can pay your taxes with cash from a non-retirement account.

How can I estimate my tax liability on an IRA conversion?

Your tax liability is based on two things: the taxable income generated by the conversion and your applicable tax rate. To determine what portion of your conversion is taxable income, you need to know the types of contributions in all of your non-Roth IRAs. This is because your contributions to a non-Roth IRA could be either pretax (i.e., you *took* an income tax deduction when you made the contribution) or after tax (i.e., you *did not take* an income tax deduction when you made the contribution).

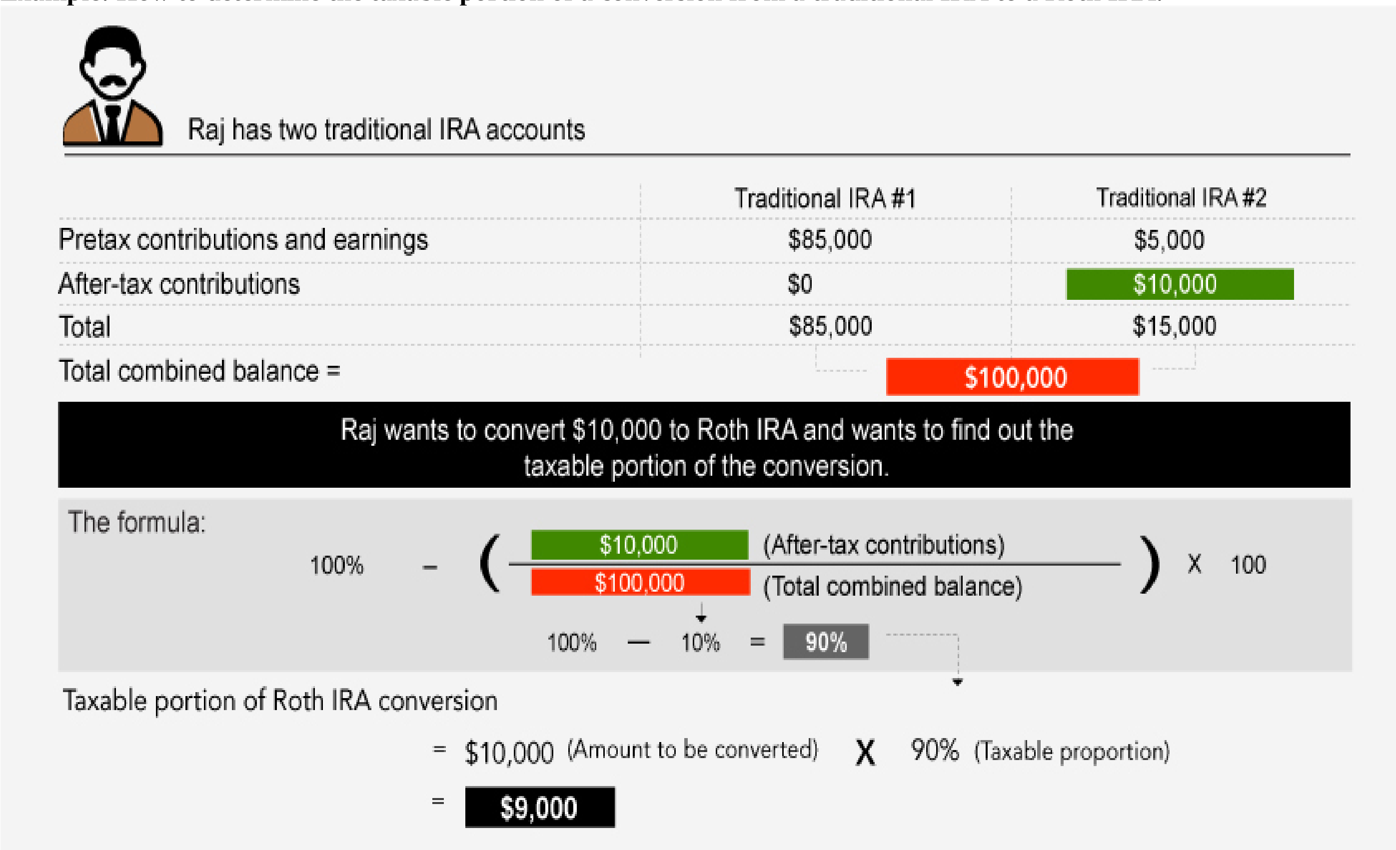
Estimating the taxable income from a conversion is straightforward if you've never made after-tax contributions to any non-Roth IRA. If that is the case, whatever amount you convert will be taxable income. It can become a little tricky if you have after-tax contributions in any of your non-Roth IRA accounts.

Here are some general guidelines for converting after-tax (non-deductible) contributions in non-Roth IRAs:

According to IRS rules, you cannot cherry-pick and convert just after-tax contributions (leaving pretax amounts in the account) in your eligible non-Roth IRAs so you won't incur any taxes. Instead, you need to determine the percentage of after-tax contributions across all your non-Roth IRAs. Then use that percentage to determine the portion of the conversion that is not taxable. To calculate this percentage, you need to total both the balances and the after-tax amounts in all non-Roth IRAs in your name, even if they are held at different IRA providers. (Don't include your spouse's IRAs or any inherited IRAs when doing this.) In simpler terms, think of all your non-Roth IRAs as one account.

Let's look at an example (see chart below, too). Raj has $100,000 eligible for conversion in two traditional IRAs. Traditional IRA #1 has $85,000 in pretax contributions and earnings; traditional IRA #2 has $10,000 in after-tax contributions and $5,000 in earnings (pretax), for a total of $15,000. Raj wants to convert $10,000 this year. Ninety percent ($90,000) of the total eligible IRA balance ($100,000) is in pretax contributions and earnings. So his taxable percentage is 90%. For the $10,000 conversion amount, that's $9,000.

Example: How to determine the taxable portion of a conversion from a traditional IRA to a Roth IRA.



This hypothetical example shows how to figure out what part of an IRA conversion is taxable income.

Tip: If you and your spouse both have conversion-eligible non-Roth IRAs, you may want to compare your total percentage of pretax contributions and earnings with that of your spouse. Why? If your spouse has IRAs with mostly after-tax contributions and you have IRAs with mostly pretax contributions, you might consider converting your spouse's IRAs before yours to reduce the potential tax impact of conversion. Converting when after-tax contributions are a high proportion of your total IRA balances is advantageous, because after-tax contributions aren't subject to taxes, but also because of the tax-free earning potential once they are in a Roth IRA account. While after-tax contributions are not taxable when withdrawn from a non-Roth IRA account, the earnings they generate are. So by converting to a Roth IRA before those earnings are generated, you could potentially reduce taxes.

Can I convert money from a traditional 401(k) to a Roth IRA?

If you no longer work for the company—whether you are retired or changed jobs—you can convert eligible non-Roth 401(k) money to a Roth IRA.

If you have only pretax money in your 401(k), you will need to pay taxes on the entire amount you convert to a Roth IRA. If you have both after and pretax money, the tax treatment and conversion rules are a bit different. According to the IRS, you can roll over **after-tax contributions** from a 401(k) plan or other workplace retirement plan separately from the **pretax** earnings—as long as the earnings on the after-tax contributions are also distributed from the plan at the same time. Therefore, if you made **after-tax contributions** to the 401(k), you can roll them directly into a Roth IRA without paying taxes on the after-tax amount as long as the associated pretax earnings are also distributed from the plan at the same time. You may also either convert any **pretax** 401(k) money to a Roth IRA, and pay the associated taxes, or roll it into a traditional IRA, and pay no current taxes. Of course, there are other factors to consider when converting or rolling over pretax money, so consult a tax professional.

Consider this example. Let's say you have $50,000 in **after-tax contributions** and $50,000 in **pretax** contributions and earnings, for a total of $100,000, in your 401(k) account from your former employer. You want to put some of that money into a Roth IRA. You can roll the $50,000 in **after-tax contributions** to a Roth IRA and pay no taxes. Because the IRS guidance is clear that you must include a proportional amount of pretax and after-tax amounts from the 401(k) at the same time, you also need to do something with the $50,000 in **pretax** money. It would be subject to taxes if you rolled it into the Roth IRA, so consider rolling it into a traditional IRA, which would not generate any tax liability this year.

Do I still need to take an MRD (minimum required distribution) in the year I convert?

Yes. People age 70½ and older are generally required to take an MRD, also called an RMD (required minimum distribution), every year from their tax-deferred retirement accounts (traditional, SEP, rollover, and SIMPLE IRAs, and workplace plan accounts). MRD amounts are not eligible to be converted to a Roth IRA. IRS rules specify that you must satisfy the MRD for the year you convert before initiating a Roth IRA conversion. Converting the MRD amount can result in an excess contribution to the Roth IRA and can trigger possible excise taxes. Instead, you can satisfy your MRD amount for your IRAs from any one or more of your non-Roth IRAs (other than an inherited IRA).

Say, for example, you have a $100,000 traditional IRA with a $7,000 MRD for the current year. If you were to convert the entire balance to a Roth IRA, you'd want to satisfy the MRD first. If you didn't, the $7,000 MRD amount would be considered a contribution to the Roth IRA, not a conversion. In this example, you'd effectively be making a $93,000 conversion and a $7,000 Roth IRA contribution. If you were not eligible to make a Roth IRA contribution of that size because your income was too high, you didn't have enough earned income, or the MRD amount was above the annual Roth IRA contribution limit, you might be subject to IRS excess contribution penalties, including excise taxes of 6% annually until the excess contribution is corrected. To avoid this situation, take your MRD from your traditional IRA(s) (other than an inherited IRA, which has its own MRD) before converting. If you have already done a conversion in the current tax year but didn't take the MRD, you should speak with your tax adviser.

How does my state tax Roth IRA conversions?

A Roth IRA conversion is a taxable event. If your state has an income tax, the conversion will likely be treated as taxable income by your state, as well as for federal income tax purposes. Because each state's income tax rules are different, however, it makes sense to check with a tax adviser before you convert.

In conclusion

We believe that because of the tax-free growth potential and withdrawals, most investors should consider having a Roth IRA as part of their overall retirement plan. But deciding whether to convert isn't necessarily a straightforward decision. That's why we suggest that you carefully assess your situation and check with a tax adviser to help you make an informed decision.

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1. A distribution from a Roth IRA is tax free and penalty free provided that the five-year aging requirement has been satisfied and at least one of the following conditions is met: you reach age 59½, become disabled, make a qualified first-time home purchase, or die.