Converting a traditional IRA to a Roth IRA

A Roth IRA can be attractive to taxpayers for a number of reasons: qualifying distributions are tax-free, it provides future tax management flexibility, and required minimum distribution (RMD) rules do not apply to account owners. To take advantage of a Roth IRA’s potential benefits, qualifying taxpayers can fund a Roth IRA through annual contributions, rollovers of “Roth” assets from an employer-sponsored retirement plan or by converting assets to a Roth IRA.

Who can convert?

Effective January 1, 2010, all taxpayers, regardless of their income or tax filing status are able to convert assets to a Roth IRA.

You can convert assets in traditional IRAs, SEP IRAs and SIMPLE IRAs (SIMPLE IRA participant account must be funded for at least two years) to a Roth IRA. In addition, an individual can directly convert assets from a qualified employer retirement plan, such as a 401(k) or 403(b), to a Roth IRA, bypassing their traditional IRA.

However, the fact that you can convert assets to a Roth IRA doesn’t necessarily mean that you should. There are a number of factors that you need to consider.

Why should you consider a Roth conversion?

Qualifying distributions from Roth IRAs are tax free

A distribution from a Roth IRA is a “qualifying distribution” and is completely tax-free (and penalty-free) if it is taken at least five years after you first establish a Roth IRA, and if one of the following applies:

• You are age 59½ or older
• You have a qualifying disability

The distribution is taken for a qualifying home purchase ($10,000 lifetime limit)
• The withdrawal is made by your beneficiary, after your death

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.

Tax-free withdrawals of contributions

Even if you take a distribution that isn’t a “qualifying distribution,” you may not be taxed on the full amount of the distribution. That’s because when you withdraw funds from your Roth IRA, distributions are treated as consisting of your contributions first and investment earnings last. Since amounts that represent your contributions have already been taxed, they are not taxed again when you take a distribution from the Roth IRA. Only the portion of a non-qualified distribution that represents earnings will be taxed and possibly penalized.

A distribution representing your annual contributions will not be subject to the 10% pre-mature distribution penalty. However, in the case of a conversion, the 10% pre-mature distribution penalty may apply if you withdraw funds from your Roth IRA within five years of the conversion, and no exception to the penalty applies.

No RMDs for account owners

You and your spouse are not required to take any distributions from your Roth IRAs during your lifetime(s). This can be a significant advantage in terms of your estate planning and may be a good reason to consider converting funds. A non-spouse beneficiary, however, is required to take RMDs upon inheriting Roth IRA assets.

Future tax management flexibility

For a number of reasons, many individuals believe that their personal tax rate will likely remain the same, or increase, in the future. It could be that you are relatively young and expect your salary to rise, you think tax rates will increase in the future, or you expect that in retirement your taxable income will be as high—or higher—than it is today. A Roth IRA allows you to protect your retirement savings from the prospect of rising taxes and provides you with greater tax management flexibility in the future.

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Questions and answers

Can I convert if I am over age 70 1/2?

You can convert assets to a Roth IRA regardless of your age. You cannot convert your RMD to a Roth IRA—it must be distributed to you prior to your conversion.

Can I do a partial conversion?

Yes, you can convert only a portion of your traditional IRA to a Roth IRA. The funds you convert to the Roth IRA will be subject to federal income tax. If you have ever made nondeductible (after-tax) contributions to your IRA, 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 I calculate the portion of my conversion that represents nondeductible contributions?

If you have ever made nondeductible contributions to your traditional IRAs, you calculate and report the taxable and non-taxable portions of the converted funds using IRS Form 8606. Basically, you calculate the ratio of all your non-deductible contributions to the total balance of all of your traditional IRAs, including SEP IRAs and SIMPLE IRAs. That ratio is then applied to any distribution from any of your traditional IRAs, including a conversion to a Roth IRA. So, if 30% of the total balance of all of your traditional IRAs represents non-deductible contributions, 70% of the funds that you convert to a Roth IRA would be taxable, and 30% would not.

Can I convert only my “nondeductible” IRA?

No, the IRS makes you aggregate all your traditional IRAs (including SEPs and SIMPLEs) when calculating the taxes due whenever you take a distribution from (or convert) any of your IRAs.
Can a decedent IRA be converted to a Roth IRA?

Traditional IRA assets inherited by a non-spouse beneficiary cannot be converted to a decedent, or beneficiary, Roth IRA.

However, a non-spouse beneficiary inheriting a qualified plan (401(k), pension, profit sharing) can convert these assets to a decedent Roth IRA by doing a direct conversion from the qualified plan.

Conclusion

A Roth IRA can be an excellent way to help you fund the type of retirement you dream of. Your financial advisor will work with you and your tax and legal advisors to assess your current situation, your assets, goals and objectives, and assist you in determining if converting assets to a Roth IRA is the right strategy for you. They will also provide you with the information you need in order to make your investment decisions.