To Roth or Not

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Introduction

Tax law allows all taxpayers (without income limitation) to convert all or part of their traditional IRAs to Roth IRAs. Even though conversion to Roth status is available to all taxpayers, income limits continue to deny high-income taxpayers the privilege of directly contributing to Roth IRAs. High income taxpayers can, however, contribute to a traditional IRA and immediately convert to a Roth IRA. Also, qualified pension and profit-sharing account balances may, under some plans, be distributed directly to a Roth IRA.

Why conversion is a good idea –

1. Roth contributions can be withdrawn at any time without tax or penalty. Withdrawal of Roth account earnings are tax-free after five years of holding and age 59½. Earlier withdrawals of Roth account earnings are subject to penalty tax at ten percent unless related to death, disability, or certain other exceptions including a first-time home purchase (up to $10,000). Heirs do not owe any income tax on Roth distributions after the original five-year holding period requirement has been met.
2. Roth IRAs have no required distributions for the lifetime of the taxpayer or surviving spouse beneficiary. Distribution is required within ten years for heirs other than the surviving spouse. The entire accumulation can be distributed near the end of the 10-year period.
3. The risk of a tax rate increase is reduced. When converting, the tax is paid on the amount converted, and there is no risk under current law of future increases nor benefit from any future decreases in tax rates.
4. The amount of income tax paid on conversion is removed from the estate (death) tax base.
5. If an IRA beneficiary is a trust that may accumulate income, conversion avoids the higher compressed trust tax bracket on future distributions.

Tax on Converting the IRA

The taxpayer is required to pay tax only on the portion of the IRA on which taxes have not been previously paid. In other words, nondeductible contributions included in converted traditional IRAs are not taxed. The taxable income from conversion is the fair market value of the converted amount at the date of conversion minus the taxpayer's nondeductible contributions (basis) includable in the amount converted. All IRA accounts must be aggregated to determine the basis for this purpose.

Pension and Profit-Sharing Plan Amounts

Some taxpayers with minimal traditional IRA accounts have significant qualified plan accounts; that is, profit-sharing, money purchase pension plan, and 401(k) accounts. These accounts may be transferred directly to Roth IRAs. Many profit-sharing plans and 401(k) plans allow, or could be amended to allow, in-service distributions. Where in-service distributions are allowable, the accounts could be transferred trustee-to-trustee or distributed to the participant (subject to income tax withholding – see question No. 13) and rolled over within 60 days. Accordingly, taxpayers with significant profit-sharing or 401(k) balances whose plans allow or could be amended to allow in-service distributions have the opportunity of converting all or some of their retirement savings to Roth IRAs. Those with significant money purchase pension balances who are age 62 or older might be able to arrange an in-service distribution making the Roth conversion available. In summary, profit-sharing, 401(k), and money purchase pension plans may be considered for possible conversion to Roth status. (See attached Rollover Chart)

Some Questions on Conversion

1. Who Should Consider Converting?

1. Those who expect higher tax rates in the future.
2. Those expecting above-average asset appreciation in the IRA.
3. Young people – they receive a longer period of tax-free compounding and might achieve conversion at lower tax rates.
4. Those who will not consume their IRA funds during retirement as they can leave their Roth IRAs to compound, tax-free for up to 10 years after death for their children or grandchildren.
5. Those who will pay death taxes – they will reduce their estate by the amount of income tax paid on conversion to Roth. They will leave an asset with the very valuable characteristic of long-term (at least 10 years), tax-free compounding, but it will be valued for death tax purposes identically to assets without that characteristic.
6. Those who are leaving IRAs to a trust that might want to accumulate trust income as the compressed trust tax brackets are avoided.

2. Who should probably not convert?

1. Those who expect future distributions to be taxed at a rate significantly lower than their tax rate on conversion.
2. Those who would have to use IRA or other tax-deferred funds to pay the conversion tax (especially if a withdrawal penalty would apply).

3. When should the conversion occur?

The earlier the conversion the greater the Roth benefit from tax-free earnings. However, conversions might be prudently delayed or done in a serial form where conversion at a lower tax rate is possible.

4. Can I convert a non-deductible IRA?

Yes, the taxable income is the excess of the FMV at conversion over the basis (Form 8606), subject to a pro-rata rule for partial conversions. (see question 5)

5. What is the pro-rata rule?

The pro-rata rule requires that, on conversion, the taxpayer must total the fair market values of all traditional IRAs – both deductible and non-deductible. The taxpayer then divides the total basis by the total fair market value of all of the traditional IRAs to determine the percentage of the converted IRAs allocable to basis recovery. The basis recovery amount is subtracted from the converted fair market value to determine the taxable gain from conversion. For example:

> Taxpayer has a $50,000 fair market value IRA with a basis of $35,000 and a $200,000 fair market value IRA with zero basis. If the taxpayer converts both, the income is $215,000. If only $50,000 is converted, the taxable income is $43,000 ($35,000 ÷ $250,000 = 14%; $50,000 x 14% = $7,000: $50,000 - $7,000 = $43,000), and the taxpayer has $28,000 of basis remaining in the $200,000 traditional IRA.

6. I have decided to make the Roth conversion this year. Can I avoid taxation on my required minimum distribution for this year?

No, the required minimum distribution for the current year cannot be converted to Roth. You must take that distribution, and you may then convert the balance.

7. I currently have my IRA 50% in fixed income and 50% in equities. If I convert half of my IRA to a Roth, which half (fixed income or equities) should I site in the Roth?

The half that you expect to have the higher rate of return (the equities) should be in a Roth IRA.

8. If I convert my IRA to a Roth, can I reverse my conversion?

Conversions of traditional IRAs into Roth IRAs occurring prior to January 1, 2018 could be reversed by recharacterization. For 2018 and later conversions, the Tax Cuts and Jobs Act, effective January 1, 2018, prohibits the reversal of a conversion of a traditional IRA into a Roth IRA. Although recharacterizations of contributions are still generally available for other contributions to IRA accounts, recharacterizations can no longer be used to unwind a Roth conversion.

9. What pre-tax savings can be converted?

Traditional IRAs, deductible or non-deductible, SEP-IRAs, and SIMPLE IRAs (after two years) may be converted. It is also possible to convert the following tax-deferred plan accounts: 401(k), 403(b), governmental 457(b), profit-sharing, and money purchase pension where in-service distributions are available under the terms of the plan. A taxpayer who inherits an IRA from a spouse can roll the IRA to the taxpayer's own IRA and then convert to Roth. Similarly, a spouse inheriting a 401(k) plan, etc. can convert. A non-spousal beneficiary inheriting an IRA account cannot convert the inherited IRA account to a Roth IRA, but a non-spousal beneficiary inheriting a qualified plan account can convert the account to Roth.

10. I think conversion is a good idea for me except that I cannot pay all of the conversion tax without using a penalty-free distribution from my IRA. Is a partial conversion using only funds from non-IRA sources better than using some IRA funds for payment of the conversion tax?

Yes, even with penalty-free distributions from IRAs (generally over age 59½), use of IRA funds for payment of conversion tax is generally not a good idea. Using IRA funds to pay the tax does not expand the amount of investment under the tax-free umbrella as does paying the tax from outside sources. Generally, a partial conversion limited to the amount of conversion tax which can be paid from non-IRA sources is the better choice.

11. Are the income taxes paid for a conversion of a traditional IRA to a Roth IRA "income taxes" or might they be considered the "purchase of an investment?"

Tax law allows all taxpayers (without income limitations) to convert all or part of their traditional IRAs to Roth IRAs. We believe that conventional wisdom is correct in holding that the early payment of taxes is generally a bad idea. However, for some IRA owners, consideration of converting a traditional IRA into a Roth IRA and paying the related income tax now can create a very significant benefit.

Thinking about conversion to Roth raises a question – are the income taxes paid for a conversion of a traditional IRA to a Roth IRA "income taxes" or might they be considered the "purchase of an investment?"

For some taxpayers, the conversion might appropriately be viewed as the "purchase" at a bargain price of an asset which can grow tax-free. For example, assume (to remove the effect of bracket changes) that the taxpayer has a constant total state and federal tax rate of 40 percent. For this constant bracket taxpayer, $1,000 inside a traditional IRA is in effect "owned" by the taxpayer in the amount of $600 and by the taxing authorities $400. While no taxes are being paid currently (it is a tax-deferred account), all distributions will, in the future, benefit the IRA owner 60 percent and 40 percent will be consumed by income taxes. A Roth IRA conversion will cause the taxpayer to pay $400 (40 percent of $1,000) in current tax and will result in the entire amount of the IRA working for the owner tax-free for the balance of the life of the Roth IRA, which can exceed the life of its original owner. By converting to Roth, this owner has "purchased" the taxing authorities' "ownership interest" in the traditional IRA for $400. Assuming the owner's tax bracket is constant (to remove the benefit or detriment of any future change in the applicable tax rate), the taxpayer has not, from one perspective, "paid tax" of $400 but rather has purchased a $400 investment, which is likely worth more than $400 as it compounds tax-free over the balance of the taxpayer's life and, if the taxpayer predeceases a spouse, over the longer life of the spouse. Additionally, following the death of the second to die of the couple, the Roth IRA can continue to compound tax-free for almost all of the following 10 years.

For taxpayers who can pay the conversion tax from sources outside the IRA and who do not anticipate significantly reduced tax rates on IRA withdrawals, conversion allows an expansion of the tax benefits of an IRA by as much as 66⅔ percent by "purchasing" the governments' interest in the traditional IRA.

12. Why is the Roth conversion suggested for those who will pay death taxes?

The death tax base is decreased by the income taxes paid on the conversion with the resulting death tax savings. The death tax savings has a present value in excess of the future benefits of the income tax deduction for the estate tax on income with respect to a decedent. For example, converting $100,000 with a 40 percent income tax rate will decrease the taxable estate by the $40,000 of income taxes paid. Assuming a 40 percent death tax rate, the death tax will decrease by 40 percent of the income taxes paid or $16,000. Without the conversion, the estate tax will be $16,000 more, and the heir will pay income tax on distributions partially offset by an itemized deduction of $16,000 spread out over the IRA distribution years, usually with a significantly higher present value cost than the income tax cost of conversion.

13. For those currently not eligible to contribute directly to a Roth, but with a traditional IRA, profit-sharing, 401(k), etc., what is a simple way to convert?

You might open a traditional IRA and contribute the maximum non-deductible contribution for the current year. In effect, the current contribution, except to the extent taxable under the pro-rata rule (see Question No. 5), will become the equivalent of a current year Roth contribution when you convert to Roth.

You can also roll over an eligible profit-sharing distribution, 401(k) distribution, etc. to a traditional IRA before conversion, or better yet, directly and irreversibly to a Roth IRA. This plan to Roth IRA rollover can be accomplished by trustee-to-trustee transfer, by transfer from the plan to a Roth IRA with the same custodian, or by rollover of an eligible distribution from the plan that is rolled over by the recipient into a Roth IRA within 60 days after the distribution. However, because plan distributions to an individual are subject to required income tax withholdings, they are not generally appropriate for rollover conversions. The better choice is usually direct transfer.

ROLLOVER CHART

Roll From		Roll To							
		Roth IRA	**Traditional IRA**	**SIMPLE IRA**	**SEP-IRA**	**Governmental 457(b)**	**Qualified Plan**[1] (pre-tax)	**403(b)** (pre-tax)	**Designated Roth Account** (401(k), 403(b) or 457(b))
Roll From	**Roth IRA**	Yes[2]	No	No	No	No	No	No	No
	Traditional IRA	Yes[3]	Yes[2]	Yes[2, 7], after two years	Yes[2]	Yes[4]	Yes	Yes	No
	SIMPLE IRA	Yes[3], after two years	Yes[2], after two years	Yes[2]	Yes[2], after two years	Yes[4], after two years	Yes, after two years	Yes, after two years	No
	SEP-IRA	Yes[3]	Yes[2]	Yes[2, 7], after two years	Yes[2]	Yes[4]	Yes	Yes	No
	Governmental 457(b)	Yes[3]	Yes	Yes[7], after two years	Yes	Yes	Yes	Yes	Yes[3,5]
	Qualified Plan[1] (pre-tax)	Yes[3]	Yes	Yes[7], after two years`	Yes	Yes[4]	Yes	Yes	Yes[3,5]
	403(b) (pre-tax)	Yes[3]	Yes	Yes[7], after two years	Yes	Yes[4]	Yes	Yes	Yes[3,5]
	Designated Roth Account (401(k), 403(b) or 457(b))	Yes	No	No	No	No	No	No	Yes[6]

[1]Qualified plans include, for example, profit-sharing, 401(k), money purchase, and defined benefit plans.

[2] Only one rollover in any 12-month period.

[3]Must include in income.

[4]Must have separate accounts.

[5]Must be an in-plan rollover.

[6]Any nontaxable amounts distributed must be rolled over by direct trustee-to-trustee transfer.

[7]Applies to rollover contributions after December 18, 2015. For more information regarding retirement plans and rollovers, visit Tax Information for Retirement Plans.