

Roth IRAs and Conversions

When the law that created Roth IRAs was originally enacted there were two eligibility limits placed on them. The first affected an individual's ability to contribute to the Roth- contributions are subject to "income limits", meaning that if an individual made over a certain amount in modified Adjusted Gross Income (MAGI), their ability to contribute could be reduced or eliminated. The second set of limitations affected conversions from traditional IRAs to a Roth. There was a \$100,000 MAGI limit on conversions, and individuals who were married but filing separate tax returns were prevented from converting. Understandably, these limits prevented many higher-income individuals from taking advantage of the Roth IRA.

Although the income limitations are still in place for contributions to a Roth IRA, they no longer apply to conversion eligibility. New rules that went into effect January 1, 2010, allow virtually everyone to convert their traditional IRAs to a Roth. This brochure outlines many of the factors that should be considered before transacting a conversion. If you haven't considered converting to a Roth before, now may be the time!

Roth vs. Traditional

To understand Roth conversions and their impact, you must first understand the difference between a traditional IRA and a Roth IRA.

Traditional IRA

A traditional IRA is an individual retirement account that is set up by an individual for their own personal benefit. Generally, the only requirement to contribute to a traditional IRA is that you have sufficient earned income to warrant the contribution (for example, you must have at least \$5,500 in earned income to be eligible for a \$5,500 contribution).

You must be under age 70 ½ to be able to contribute to a traditional IRA. Contributions made to a traditional IRA are tax-deductible, provided you meet the income eligibility limits. Interest, dividends and capital gains in the account grow tax-deferred until they are distributed from the IRA, when they generally become taxable as ordinary income.

At age 70 ½, a traditional IRA owner must begin taking what is known as Required Minimum Distributions (RMDs). These amounts are not eligible for rollover to another IRA or qualified plan and they are not eligible for conversion to a Roth IRA.

Roth IRA

A Roth IRA is also an individual retirement account that is set up by an individual for their own personal benefit. Unlike a traditional IRA, there are income eligibility requirements (meaning your modified Adjusted Gross Income must be below a certain level to be eligible to contribute to a Roth IRA) as well as the earned income requirement.

Contributions made to a Roth IRA are not tax deductible at the time of contribution. However, the assets grow and are distributed tax-free provided the distributions are qualified. In addition, the Roth IRA has no RMD requirement while the original Roth IRA owner is alive, and contributions can continue to be made after age 70 ½.

If you want to contribute to a Roth IRA, but are not able to because of the income limitations, or if you have a traditional IRA but would like to take advantage of the Roth IRA benefits, you may want to consider a Roth IRA conversion. Read on for more information on Roth IRA conversions!

What is a Roth IRA Conversion?

A Roth conversion is completed when a traditional IRA owner moves his or her traditional IRA assets into a Roth IRA. In addition, qualified plan (pension, 401(k), profit sharing, etc.) participants may elect to convert their assets to a Roth IRA.

What assets are eligible for conversion?

Generally, all traditional IRA, rollover IRA, SEP IRA, and SIMPLE IRA (after meeting the two-year holding period) assets are eligible for conversion. In addition, most 401(k), 403(b), profit sharing and pension assets are also eligible for conversion when they are able to be distributed from the plan and do not consist of Required Minimum Distribution (RMD) amounts.

Beneficiaries inheriting qualified plan assets also have the unique opportunity to convert the qualified plan assets to a beneficiary Roth IRA. Unfortunately, this option is not available to those non-spouse individuals who are inheriting traditional IRA assets. In addition, non-spouse beneficiaries who have inherited qualified plan assets can only convert those assets to a beneficiary Roth IRA through a direct trustee to trustee rollover conversion (the assets being converted must be rollover eligible and cannot consist of RMDs).

Is a Conversion Right For You?

Before transacting a conversion, there are some things you should consider:

- Can you afford to pay the conversion tax?
Pre-tax amounts that you convert to a Roth IRA must be included in income, and are generally subject to income taxation. If you use your IRA assets to pay the conversion taxes, you are depleting the benefits of your IRA. Additionally, if you are under age 59 ½, you will owe taxes and penalties on the amount used to pay the tax. If you cannot afford to pay the tax due on a conversion, a conversion may not be right for you.
- What tax bracket will you be in during the year of conversion versus the tax bracket you expect to be in when you begin distributions from your Roth IRA?
If you will be in a higher tax bracket when you need to access your IRA assets, a Roth IRA conversion could help you by “charging” the conversion income tax now, while you’re in your lower tax-bracket, and allowing for tax-free distributions when you need access to the funds and are in a higher tax bracket. Keep in mind that the amount converted may put you into a higher tax bracket.
- Would you like to avoid taking RMDs after reaching age 70 ½?
If you are approaching RMD age, but don’t want or need to take distributions from your IRA, a Roth IRA can solve your problem! Unlike traditional IRAs, there is no RMD requirement from a Roth IRA while the original account holder is still alive, and there is no age restriction on the ability to make contributions. In addition, a spousal beneficiary is generally not required to take RMDs either.
- What type of estate considerations do you have and who do you want the IRA to benefit (you or your beneficiaries)?
If you are looking to reduce the value of your estate so that you can pass on more substantial assets to your beneficiaries, then a Roth IRA may help you achieve this goal by incurring the conversion tax now (thereby reducing the value of your current assets) and allowing you to pass on a potentially large income tax-free account to your heirs. In addition, since there are no RMDs required, your IRA would be able to grow even larger- all tax-free for your heirs.

Keeping those considerations in mind, those who might consider converting to a Roth IRA would generally be:

- Individuals age 70 ½ and older who would like to reduce or eliminate future traditional IRA RMDs during their lifetime.
- Individuals who prefer to pay tax now, rather than later, such as those individuals who will pay income tax at the same or higher rate when withdrawals begin from their retirement accounts.
- Taxpayers with after-tax amounts in their IRA. After-tax amounts converted from a traditional IRA to a Roth IRA are generally not subject to income tax. Distributions from any traditional IRA are a pro-rata return of after-tax amounts.

Conversions of After-Tax Assets in a Traditional IRA

If you have both pre-tax and after-tax assets in your traditional IRA, you cannot convert only after-tax assets to a Roth IRA. The conversion amount will consist of a pro-rata portion of pre-tax and after-tax assets. All traditional IRA assets of an individual must be aggregated to determine the pro-rata formula.

What Are the Potential Drawbacks of a Conversion?

A conversion is not right for everyone and the decision to convert should not be taken lightly. Generally, the principal drawback to converting to a Roth IRA is that you must include the pre-tax amounts in income in the year that you convert. If your tax rate will drop in retirement, a conversion may not be in your best interest. In order for all distributions to be taken out tax and penalty free, you must meet a five-year holding requirement and you must be at least age 59 ½ or have a qualifying distribution reason.

Roth IRA Distribution Rules

If you are wondering how soon you will be able to take distributions from your Roth IRA, you should be aware of the somewhat complex Roth IRA distribution rules.

How soon can assets be withdrawn?

You can withdraw money from a Roth IRA at any time. You may owe taxes and/or penalties if you make a non-qualified distribution. A distribution is considered “qualified” (and therefore is tax and penalty free) if you have maintained a Roth IRA for at least five years and you are age 59 ½ or older. If you are not age 59 ½ or older, but the distribution is being made due to a qualified disability, is made to a beneficiary or to the estate after the death of the IRA owner, or is made for the qualified purchase of a first-home (up to \$10,000), then the distribution can still be a “qualified distribution”, provided the 5-year holding period is met.

Non-qualified distributions may be subject to tax or penalty depending on what is distributed. In a Roth IRA, distributions are made up of contribution amounts first, then conversion amounts on a first-in first-out basis, and then account earnings.

Below is a simplified chart that outlines the basic Roth IRA distribution rules*.

Order of Distribution Taken	Age of Account Owner When Distribution is Taken	
	Under 59 ½	Over 59 ½
Contributions:	Income tax-free Penalty-free	Income tax-free Penalty-free
Conversions**: (applies to each conversion separately)	Income tax-free 10% penalty may apply if within 5-year holding period	Income tax-free No 10% penalty
Earnings:	Taxable as income if distribution is non-qualified 10% penalty may apply	Taxable as income if within 5-year holding period No 10% penalty

**This table is a simplified outline used to illustrate how some Roth IRA distributions may be taxed and penalized. There are other possible exceptions to the 10% penalty that are not illustrated in this chart. For more information on distributions from a Roth IRA, please request Oppenheimer’s “Roth IRA Distributions: A General Overview” marketing piece from your Financial Advisor. Roth IRA distribution information can also be found in IRS Publication 590.*

***Please note that each conversion contribution has a separate 5-year holding period that must be met for a distribution to be a qualified distribution.*

Planning Tips!

Be aware of your tax bracket!

When considering a Roth IRA conversion, it is very important to be aware of your current tax bracket and how the resulting conversion income may affect your bracket. A conversion can take you into a different tax bracket negating the economic benefit of a conversion for some! If you are an older individual, it is also important to recognize that increasing your income could affect your social security or Medicare qualifications and/or payments.

Partial Conversions

If you do not want to convert 100% of your traditional IRA or qualified plan to a Roth IRA, then you can transact a partial conversion. A partial conversion is when an individual converts only a portion of their traditional IRA or qualified plan to a Roth IRA. This strategy may be helpful in keeping your tax liability relatively low.

Changed your mind? Consider a recharacterization!

If you have converted all, or a portion of your traditional IRA or qualified plan to a Roth IRA, and then find that it was not in your best interest to do so, you can effectively “reverse” that decision through a recharacterization.

A recharacterization allows you to treat a contribution made to one type of IRA as having been made to a different type of IRA (i.e., from a Roth IRA to a traditional IRA). A recharacterization must be completed by your tax filing deadline, including extensions.

This strategy could be helpful if:

- Your account value drops. In this scenario, you may want to recharacterize your conversion and then re-convert, so that you can pay taxes on a smaller account value.
- You find your tax bracket is higher than you expected, making a conversion less appealing.

It is important to note that if you convert, and then recharacterize that conversion, you cannot reconvert those assets until the later of 30-days after the recharacterization or the calendar year following the conversion.

Converting different assets?

If you have multiple assets that you would like to convert, one strategy is to convert each asset class into a separate Roth IRA so that if the value of one asset dips, you can recharacterize just the Roth that has decreased in value, this way you may realize less taxable income.

For example, let's say that you have a traditional IRA that is invested in \$250,000 each of equities, bonds, and cash equivalent investments, and you want to convert your entire IRA into a Roth. You convert \$250,000 of equities into one Roth IRA (1), \$250,000 of bonds into another Roth IRA (2), and \$250,000 of cash equivalents into a third Roth IRA (3). Then, in December of the year of conversion, you find that the \$250,000 of bonds has decreased to \$200,000 while the other two Roths have increased in value. At that point, you can recharacterize Roth IRA (2) and keep the Roth IRA (1) and (3) as-is. After 30 days, you can then reconvert back to a Roth IRA*.

Remember that the income tax on the conversion is based upon the value of the assets converted on their actual date of conversion. Therefore, if that value dips you are paying tax on the higher amount. A recharacterization allows you to avoid paying tax on the higher account value.

**Note- because the client in this example did a recharacterization in December, the 30-day period following the recharacterization will fall in the next tax year so the client only has to wait 30-days to reconvert.*

Personalized Illustration

Your Oppenheimer Financial Advisor can run a personalized illustration for you to show the possible benefits of a Roth IRA conversion. This illustration can outline the impact that your decision could have on your future taxes and on your beneficiaries.

Contact your Oppenheimer & Co. Inc. Financial Advisor today for assistance
with your Roth IRA conversion needs!