

Roth IRA conversions

An overview

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Key highlights

- Benefits of a Roth IRA
- Impact on Social Security
- Evaluation criteria
- Future income tax rates
- Paying the conversion tax
- Holding period before distributions
- Roth recharacterizations eliminated
- Allocating after-tax contributions to a conversion

When the Roth IRA arrived in 1998 there was wide acclaim as to its features such as tax-free withdrawals of earnings, tax-deferred growth, and account owners not being subject to required minimum distributions (RMDs); however, its availability was not universal because of the income/filing status limitations to contributing and/or converting.

The opportunity

Starting in 2010, and continuing beyond, the income/filing status limitations on conversion were removed, making conversion from qualified plans and/or Traditional IRAs into Roth IRAs available to all owners of those types of accounts. Beneficiaries of qualified plans may also convert into an inherited Roth IRA. Beneficiaries of Traditional IRAs unfortunately may not convert into an inherited Roth IRA.

Please note that the income/filing status limitations on contributions still remain.

Benefits of a Roth IRA – Taxation overview

Understanding the benefits of a Roth conversion comes through with a good understanding of the tax nature of Roth IRAs.

Order of distributions from Roth IRAs

The distributions from Roth IRAs follow the first-in-first-out (FIFO) principle. This means that the flow of distributions from a Roth IRA follows the general order listed below.

1. Contributions
2. Converted Amounts
3. Earnings

Each of these different types of dollars has its own rules, but if the rules are understood and followed their distribution from the Roth IRA may be income tax and penalty tax free.

Contributions

Contributions to Roth IRAs are withdrawn first and may be withdrawn at anytime without tax consequences, regardless of the owner's age or the age of the Roth IRA account.

Converted amounts

Converted amounts are withdrawn after contributions and are not subject to income taxation since income tax has already been paid at the time of the conversion. However, withdrawals of converted amounts may be subject to the 10% tax penalty for premature withdrawals unless the owner is over age 59 ½ **or** it's been five years since the conversion took place. Each conversion has its own five year holding period, but distributions of converted amounts come from the oldest conversions first.

Earnings — General rule

Distributions of earnings come last and may be income tax-free if the account owner is over age 59 ½ **and** it has been five years since the first contribution or conversion into a Roth IRA. If a withdrawal of earnings takes place when the owner is under age 59 ½ it may also be subject to the 10% tax penalty as well as income taxation unless one of the following exceptions applies.

Earnings — Premature withdrawal exceptions

If the owner is under age 59 ½ when a withdrawal of earnings occurs, that withdraw may be income and penalty tax free as long as its been five years since the first contribution or conversion into a Roth IRA, **and** the distribution is due to the owner becoming disabled or is made for first-time homebuyer expenses (limited to a \$10,000 lifetime maximum). Alternatively, income taxation is not avoided if it has not been over five years from the first funding of the Roth IRA, but the tax penalty for premature distributions is avoided for both disability and first-time homebuyer situations regardless of Roth IRA account age.

For distributions of earnings under age 59 ½ the tax-penalty may also be avoided, but not income taxation, if the distribution is:

- Part of a series of substantially equal periodic payments over life or life expectancy, commonly referred to as 72(t); or,
- Made for medical expenses that exceed the allowable amount of AGI for that tax year; or,
- Made to an unemployed individual after separation from employment for health insurance premiums if the individual has received federal or state unemployment compensation

- Used to pay for qualified education expenses for the owner, owner's spouse, or
- Made on account of an IRS levy under Code section 6331 on the Roth IRA.

Tax deferral

The amounts invested in a Roth IRA enjoy tax-deferred growth.

No RMDs by the owner

Roth IRA owners are not required to take Required Minimum Distributions (RMDs).

Beneficiaries

Spousal beneficiaries of Roth IRAs may re-register the Roth IRA into their own name and continue the Roth IRA on as their own without being forced to take distributions.

Non-spouse beneficiaries of Roth IRAs are subject to RMDs. However, no 10% tax penalty will apply to any distribution — required or discretionary — from an inherited Roth IRA and distributions of earnings to the beneficiary may be income tax free if it has been over five years from the owner's first funding of the Roth IRA. Beneficiaries also enjoy the same distributional ordering rules as owners — contributions, converted amounts, earnings. The beneficiary's first RMD must be withdrawn by December 31 of the year following the year of the account owner's death and must be based on the beneficiary's life expectancy.

Impact on Social Security

Tax-free Roth IRA distributions will not increase the likelihood that Social Security payments could be subject to income taxation. In contrast, distributions from Traditional IRAs, because they are usually taxable, may raise total taxable income to a level that subjects Social Security payments to income taxation.

Evaluation criteria

Evaluating the Roth conversion opportunity and taxation benefits of a Roth IRA are the first and second steps in the process, next clients have several threshold questions they need to consider to determine if a Roth Conversion makes sense for them. Implicit in this determination is also an understanding by the owner of the reason for converting — either

for retirement income or estate planning purposes or perhaps both. Determining the reason for the conversion (retirement income and/or estate planning) can help the client evaluate the trade-offs that are an inherent part of Roth conversion decision making.

Threshold question one: Future income tax rates

The first evaluation point is the client's belief in where their or their beneficiaries, personal income tax rate will be in retirement relative to where it will be in the year of conversion. If the client believes the income tax rate will be higher in retirement than it is now, then conversion may make some sense. If the income tax rate will be lower in retirement than it is now, then conversion may not make sense. If the income tax rate will be the same, then from an income tax perspective conversion is neutral. However, in a tax neutral situation not being forced to take RMDs or that beneficiaries may receive income tax-free distributions could outweigh the concern about the owner's current income taxation situation as an evaluation point.

Threshold question two: Paying the conversion tax

The second evaluation point is determining where the money will come from that will be used to pay the taxes due on the conversion. If the client must access the converted amount to pay the taxes due on the conversion, then conversion may not make sense because of the loss of the beneficial compounding effect of keeping the total converted amount together. In addition, if the client is under age 59 ½ when the conversion occurs and they take a distribution from the IRA to pay the taxes due on the conversion then the 10% penalty tax would apply to the distribution.

Threshold question three: Holding period before distributions

The third evaluation point is how quickly the client will need to access the converted amount for retirement income. Five years is a minimum appropriate holding period because of the two five year taxation driven holding periods, mentioned above, that must be considered when evaluating a Roth conversion.

Essentially, if the client is under age 59 ½ and needs to take a withdrawal from the converted Roth account within five years of the conversion, then conversion may not make sense because of the potential negative tax effects.

Beyond the five year holding periods imposed by the Roth taxation rules itself, there is also the effect of compounding to consider. This effect may dictate that a holding period of seven to ten years or longer may be appropriate to allow the Roth IRA to have enough time to grow to make back the taxes paid on the conversion.

Roth recharacterizations

The ability to undertake a recharacterization of a Roth conversion has been eliminated by the Tax Cuts and Job Act tax reform legislation passed in late 2017.

Pro-rate rule — Allocating after-tax contributions to a conversion

The pro-rata principle is designed to proportionally allocate any after-tax, non-deductible contributions inside Traditional IRAs to the amount converted to a Roth IRA. The purpose of this rule is to prevent cherry picking of accounts for conversion that are primarily composed of after-tax contributions in an attempt to reduce the amount of income tax on a conversion. The self-reporting form 8606 is used to determine the amount of any after-tax contributions to Traditional IRAs.

If you have more than one Traditional IRA account and any of those accounts contain after-tax contributions, the pro-rata rule is designed to prevent you from selecting that account alone for conversion in order to reduce the income tax owed.

The pro-rata rule requires you to look at all Traditional IRAs together and find the after-tax/pre-tax ratio of all Traditional IRAs. Then you multiply the amount being converted by the after-tax percentage to find the non-taxable amount of the conversion. Finally, you subtract the non-taxable amount of the conversion from the total conversion amount to find the taxable portion of the conversion.

Let's consider the following hypothetical example:

The client has three Traditional IRAs. The accounts have a mix of after-tax contributions and pre-tax contributions and earnings. Initially the client is interested in converting only account #2 because it contains the least amount of pre-tax dollars, thus it looks like converting that account would reduce the taxable amount of the conversion to the \$5,000 of pre-tax earnings.

Traditional IRA	After-tax contributions	Pre-tax (deductible) contributions	Pre-tax earnings	IRA values
#1	\$0	\$35,000	\$40,000	\$75,000
#2	\$20,000	\$0	\$5,000	\$25,000
#3	\$30,000	\$40,000	\$30,000	\$100,000
Totals	\$50,000	\$75,000	\$75,000	\$200,000

Instead the pro-rata rule requires that the client must first add the balance in all their IRAs together – in this case, \$200,000. Second they must find the total amount of after-tax contributions in their IRAs using form 8606 – here \$50,000. Then they divide the total after-tax nondeductible contributions by the total IRA balance: here \$50,000 divided by \$200,000. This gives you the percentage – 25%, in our example – of any conversion that's tax-free. The client then multiplies the converted amount by the after-tax percentage, to yield the non-taxable amount of the conversion: $\$25,000 \times .25 = \$6,250$. Then you subtract the non-taxable amount of the conversion from the total converted amount to get the taxable amount of this conversion: $\$25,000 - \$6,250 = \$18,750$. Thus, \$18,750 of account #2 is the taxable amount of this conversion not the \$5,000 as initially thought.

The pro-rata rule can actually be a positive for the client because it may lower the amount of the taxable amount of any conversion because it proportionally applies after-tax contributions to any conversion amount. It can also be a positive for an advisor because it can serve as a means to help the advisor uncover the client's Traditional IRA assets he may not be currently managing.

Conversion wrap-up

The unlimited conversion privilege makes Roth IRAs available to many more people than ever before. The tax-free nature of distributions from Roth IRAs may make generating and keeping retirement income easier. The tax-free nature of distributions to beneficiaries may make Roth conversion a positive wealth transfer tool for clients.

Be careful to consider the pro-rata rule when undertaking a Roth conversion.

Ultimately, the decision to undertake a conversion should be done in conjunction with the client's tax advisor, but some evaluation points they'll want to consider are the likelihood of increases in income tax rates in the future, where the money is going to come from to pay the taxes and how long before they will need access to the Roth IRA dollars.

Conclusion

The Roth IRA conversion opportunity may be a way for your client's with Traditional IRA or qualified plan rollover assets to take advantage of the Roth IRAs tax-free income privileges.



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