

# Converting a Traditional IRA to a Roth IRA

A Roth IRA can be attractive to taxpayers because qualifying distributions are tax free 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?

Under current law you can convert assets to a Roth IRA if you file your federal income tax return as a single taxpayer or married filing jointly and your MAGI for the year is \$100,000 or less. Amounts that must be included in your taxable income as a result of the conversion are not considered when determining if your annual income exceeds this \$100,000 threshold.

If your federal income tax filing status for the year is married filing separately, you currently cannot convert assets from a traditional IRA to a Roth IRA.

***Tip:** The Tax Increase Prevention and Reconciliation Act of 2005 eliminates the \$100,000 ceiling for Roth IRA conversions beginning January 1, 2010. In addition, married individuals who file separate returns will also be able to convert funds to a Roth IRA for tax years after 2009.*

If you qualify, you can convert assets in traditional IRAs, SEP IRAs and SIMPLE IRAs (those that have existed for at least two years) to a Roth IRA. In addition, beginning in 2008, 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 qualify to 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 made 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); or
- 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



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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

Roth IRAs are not subject to RMDs. Therefore, you are not required to take any distributions from your Roth IRAs during your lifetime. 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.

## Qualified Distributions from Roth IRAs are Not Included When Determining the Taxable Portion of Social Security

Converting assets to a Roth IRA may be beneficial when it comes time to begin receiving your Social Security benefits. The portion of your Social Security (if any) that is taxable depends on your MAGI and federal income tax filing status in a given year. Under current law, qualified distributions from Roth IRAs are not included when determining the taxable portion of your Social Security.

## CONSIDERATIONS

### Taxes

The assets you convert are subject to federal and possibly state income tax for the year you convert (to the extent that the converted amount represents pre-tax assets). Therefore, even if it makes overall financial sense to convert assets to a Roth IRA, paying the taxes now may not be desirable.

**Tip:** For Roth conversions made in 2010, the amount includible in gross income will be reported in equal installments over a two-year period, in 2011 and 2012. Half the income will be reported on your return for 2011, and the remaining half will be reported for 2012. Any tax incurred by conversions made after 2010 will be due in the year of the conversion.



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## Using IRA Funds to Pay Your Tax Bill

If you have to cash out part of your traditional IRA to pay the income tax that results from converting assets to a Roth IRA, the benefits of the conversion are substantially reduced. Using IRA dollars to pay the tax reduces the amount of assets in your IRAs, potentially jeopardizing your retirement goals. In addition, the IRA funds that are distributed but not converted may be subject to a 10% pre-mature distribution penalty. Paying your income tax bill with non-IRA funds is generally more advisable.

## TAX CONSIDERATIONS

If you have made only deductible contributions to your traditional IRAs, then the entire amount that you convert will be taxable. However, if you have ever made nondeductible (after-tax) contributions to your traditional IRA, those contribution amounts, or basis, will not be taxable when converted since they have already been taxed. Keep in mind, if you have multiple Roth IRAs they are aggregated for this purpose.

### Application of the 10% Pre-Mature Distribution Penalty

The 10% pre-mature distribution penalty does not apply to assets that you convert to a Roth IRA, even if you convert the assets before reaching age 59½. Any amount distributed that is not converted (for example, funds used to pay your tax bill) may be subject to the 10% pre-mature distribution penalty.

However, if you convert assets to a Roth IRA and withdraw any portion of those funds from the Roth IRA within five years, and an exception to the penalty

does not apply, the withdrawal will be subject to the 10% pre-mature distribution penalty, to the extent those funds were taxed at the time of the conversion.

## Distribution Ordering

Distributions from Roth IRAs are subject to ordering rules. They are considered distributed in the following order:

- Regular annual contributions
- Converted amounts on a first-in, first-out basis (taxable portion first)
- Earnings

**Example:** Sam, who is age 38, contributed \$3,000 to his Roth IRA in 2004. In 2005, Sam converted \$10,000 from his traditional IRA to his Roth IRA, and included this \$10,000 in his 2005 gross income. He made no further contributions to his Roth IRA. In 2008, Sam takes a \$5,000 distribution from his Roth IRA which is valued at \$13,000. None of the exceptions to the 10% pre-mature penalty distribution apply. Sam's \$5,000 withdrawal is considered to consist first of his \$3,000 regular contribution made in 2004. Sam owes no 10% pre-mature distribution penalty on this \$3,000. The remaining \$2,000 of Sam's \$5,000 withdrawal is considered to consist of funds from his conversion, and is subject to the 10% pre-mature distribution penalty.



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## QUESTIONS & ANSWERS

### Can I convert if I am over 70½?

As long as you meet the income and tax filing guidelines you can convert assets to a Roth IRA regardless of your age. You cannot convert your RMD to a Roth IRA. However, the amount of your RMD is not considered when determining if your annual income exceeds this \$100,000 MAGI threshold.

### 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 non-deductible (after-tax) contributions to your traditional IRA, you have to calculate what portion of the funds that you convert represents non-deductible 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 non-deductible contributions?

If you have ever made non-deductible 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.

Please note, you can't escape the pro-rata taxation rules by using separate IRAs. 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 I undo or re-characterize a Roth IRA conversion?

You may be able to undo or re-characterize a Roth IRA conversion by moving the amount of the conversion (plus any related earnings) back to a traditional IRA. Generally, the deadline for re-characterizing a Roth IRA conversion is the due date of your federal income tax return (including extensions) for the year of the conversion.

## CONCLUSION

A Roth IRA can be an excellent way to help you fund the type of retirement you dream of. Your RBC Wealth Management Financial Consultant will work with you and your tax and/or 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. He or she will also provide you with the information you need in order to make your investment decisions.

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