Investment Planners, Inc.
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# Roth IRA Conversions

***Working around the income limits***

*If the income limits prevent you from making annual contributions directly to a Roth IRA, there's a simple workaround using the new liberal conversion rules:*

*Generally, anyone younger than age 70½ with taxable compensation can make nondeductible contributions to a traditional IRA, regardless of income, marital status, or participation in an employer retirement plan. So you can make your annual contribution initially to a traditional IRA and then immediately convert the traditional IRA to a Roth, using the new liberal conversion rules. This is often called a "back door Roth IRA." But remember, you'll need to aggregate all your traditional IRAs when you calculate the taxable portion of the conversion.*

# Roth Conversions: Easier after 2009

## What changed?

Before 2010 you could only convert a traditional IRA to a Roth IRA, or roll an eligible rollover distribution (ERD) from an employer plan to a Roth IRA, if you met two requirements:

- Your modified adjusted gross income (MAGI) couldn't exceed $100,000, and
- Your filing status couldn't be married filing separately

Beginning January 1, 2010, the income and filing status requirements for Roth conversions were entirely eliminated, allowing more individuals the option of converting funds to a Roth IRA. Under the new rules, regardless of your income or filing status, you can roll over or convert the following to a Roth IRA:

- A traditional IRA, SEP-IRA, or SIMPLE IRA (after two years of participation)
- An ERD from your retirement plan (for example, a 401(k) or a 403(b) plan)
- An ERD from a retirement plan for which you are a beneficiary

***Note:*** *As before, you can also roll over funds from one Roth IRA to another, or from a Roth retirement plan account to a Roth IRA, without restriction.*

## What didn't change?

In general, you can contribute up to $6,000 to an IRA (traditional, Roth, or a combination of both) for 2019. If you're age 50 or older, you can contribute up to $7,000. (Your contributions can't exceed your taxable compensation for the year, though.)

However, your ability to make annual contributions to a Roth IRA in 2019 depends on your income level (MAGI):

| If your federal filing status is: | Your contribution is reduced if your MAGI is: | You can't contribute if your MAGI is: |
|---|---|---|
| **Single or head of household** | More than $122,000 but less than $137,000 | $137,000 or more |
| **Married filing jointly or widow(er)** | More than $193,000 but less than $203,000 | $203,000 or more |
| **Married filing separately** | More than $0 but less than $10,000 | $10,000 or more |

# Converting a Traditional IRA to a Roth IRA

## Ways to convert

You can convert a traditional IRA to a Roth IRA in three ways.

1. You can make a rollover. You receive a distribution from your traditional IRA and then roll it over to a Roth IRA within 60 days after the distribution.
2. You can make a trustee-to-trustee transfer. You direct the trustee of the traditional IRA to transfer an amount from your traditional IRA to the trustee of your Roth IRA.
3. You can make a "same trustee" transfer. If the trustee of your traditional IRA also maintains your Roth IRA, you can direct the trustee to simply transfer an amount from your traditional IRA to your Roth IRA.

***Note:*** *You can't roll over or convert required minimum distributions (RMDs).*

## Calculating the conversion tax

When you convert a traditional IRA to a Roth IRA, you're taxed in the year of conversion as if you made a withdrawal from your traditional IRA.

But there's one important difference: the 10% early distribution penalty tax doesn't apply to Roth conversions, even if you haven't yet attained age 59½. But be careful — if you make a nonqualified withdrawal of converted funds from your Roth IRA within five years after the conversion, the IRS may recapture that early distribution penalty unless you're 59½ or another exception applies.

If you've made only deductible contributions to your traditional IRA, then the tax calculation is easy: the entire amount you convert will be subject to federal income tax. But if you've made any nondeductible — that is, after-tax — contributions to your traditional IRA, the calculation is a little more complicated.

If you've made nondeductible contributions to your traditional IRA, then any time you take a distribution, your withdrawal is treated as a pro rata amount of taxable and nontaxable dollars. Since conversions are taxed the same as withdrawals, the same rule applies: if you've made nondeductible contributions to your traditional IRA, part of your conversion will be taxable, and part nontaxable. This means that you can't convert just the nontaxable portion of your traditional IRA in order to wind up with a tax-free conversion.

In addition, whenever you take a withdrawal from any traditional IRA you own, you're required to aggregate that IRA with all other traditional IRAs you own, including any SEP and SIMPLE IRAs, when you calculate the

*Rollovers from employer plans can be complicated and can have serious tax implications, so before you take any action make sure you understand all of your options, any fees and penalties that may apply, and other special tax rules that may be available to you.*

taxable and nontaxable portion of your withdrawal. This applies to conversions as well. This means that you can't just transfer the nontaxable portion of a traditional IRA to a separate IRA, and then convert that new IRA to a Roth in order to avoid all conversion taxes. See IRS Form 8606, reprinted at the end of this workbook.

## Converting Employer Plan Distributions to a Roth IRA

You can also fund a Roth IRA by making a rollover from an employer plan like a 401(k). These rollovers are also commonly called conversions, and are subject to many of the same rules as traditional IRA to Roth IRA conversions.

When you receive a distribution from your 401(k) or other employer plan, your employer is required to tell you whether the distribution is eligible to be rolled over. If it is, you'll have the option of rolling over all or part of that distribution to either a traditional IRA or a Roth IRA.

If you roll the distribution over to a Roth IRA, the amount you roll over — except for any after-tax contributions — will be subject to federal income taxes. And just like traditional IRA conversions, anyone can roll over funds to a Roth IRA in 2019, regardless of income limits or filing status.

***Note:*** *You can't roll over or convert RMDs, hardship withdrawals, or certain periodic payments.*

## Is a Roth Conversion Right for You?

While Roth IRAs are excellent retirement savings vehicles, is a conversion right for you? The answer is a complicated one, and depends on your particular situation and goals. Here are some factors to consider:

### Arguments for

- Converting may make sense if you believe you'll be in a higher tax bracket in the future — when you begin taking distributions — than in the year you make the conversion. However, tax rates are just one factor to consider.
- Qualified distributions are tax free. That means in the future you can supplement any taxable income you have with tax-free income that won't impact the taxation of your Social Security benefits, or affect any tax benefits that are keyed to your adjusted gross income.
- You're required to start taking distributions from traditional IRAs when you turn 70½. But with Roth IRAs, you never have to take a withdrawal during your lifetime. This can allow your IRA assets to enjoy the benefit of tax-free compounding for a longer period of time. And because you aren't required to take distributions, you can potentially leave more dollars income tax free to your heirs, especially if you don't need the Roth IRA assets to fund your retirement.

### Arguments against

- If you expect to be in a lower tax bracket in the future, when you'll begin taking distributions, making a conversion now may be unwise.
- You'll have to pay federal income tax on all or part of the amount you convert.
- If you'll have to use IRA dollars to pay the conversion tax, the benefits of converting to a Roth IRA are substantially reduced. Using IRA dollars to pay the tax reduces the amount of funds in your IRAs, potentially jeopardizing your retirement goals. In addition, the IRA funds used to pay the tax may themselves be subject to federal income tax and possibly a premature distribution penalty tax.
- If you'll need to use the funds before you're eligible for tax-free qualified distributions, any earnings you withdraw will be subject to income tax and penalties. In addition, the IRS may recapture all or part of any penalty tax you should have paid when you made the conversion.
- One of the main reasons to consider contributing to a Roth IRA is that qualified distributions are completely tax free. However, some experts are skeptical that this will always remain the case, given the uncertain status of Social Security and the projected lost federal revenue attributable to Roth IRAs.
- Although most states follow the federal tax treatment of Roth IRAs, you should check with a tax professional regarding the tax treatment of Roth IRAs in your particular state.

## Roth IRA "Qualified Distributions"

### Tax-free distributions

The main tax feature of Roth IRAs, and the reason they are attractive retirement savings vehicles, is the possibility of tax-free withdrawals.

Roth IRAs are funded with after-tax contributions, so you never pay income tax on those contributions when they are distributed from the IRA. But if the distribution is "qualified," earnings, too, escape taxation. Therefore, it's important to understand what constitutes a "qualified distribution" so that you can avoid income tax (plus a potential 10% early distribution penalty tax) on any earnings that are distributed to you.

In order to be a qualified distribution, your payment must be made both:

**1.** After you satisfy a five-year holding period, **and**
2. After you have a qualifying event:
    - Age 59½
    - Disability
    - First-time homebuyer expenses ($10,000 lifetime from all IRAs)
    - Death

## The five-year rule

Distributions cannot be qualified if you haven't satisfied a five-year holding period. You have one five-year holding period that applies to all of your Roth IRAs for this purpose.

The five-year period starts on the first day of the tax year for which you first make a contribution to any Roth IRA. This can be done either by making a regular annual contribution to a Roth IRA, by rolling over an ERD from an employer-sponsored retirement plan to a Roth IRA, or by converting a non-Roth IRA to a Roth IRA. The five-year period ends after five calendar years.

Keep in mind that you can generally make a regular Roth contribution for a tax year until April 15 of the following tax year. For example, if you make your first Roth IRA contribution on April 15, 2020, and designate that contribution for 2019, your five-year holding period will begin on January 1, 2019.

The five-year holding period also applies to your beneficiaries after your death. So even though your death is a qualifying event, your beneficiaries will not be able to receive tax-free qualified distributions from your Roth IRA until the five-year holding period is satisfied.

Spouse beneficiaries have additional options. Your spouse can roll your Roth IRA proceeds into his or her own Roth IRA. If your spouse is your sole beneficiary, your spouse can also treat your Roth IRA as his or her own. In either case, your spouse will be able to use either your holding period or his or her own, whichever is more favorable. That is, the five-year holding period will begin on January 1 of the tax year your spouse first established any Roth IRA or, if earlier, January 1 of the year in which you first established any Roth IRA.

***Caution:*** *If you receive a nonqualified distribution from a Roth 401(k) or 403(b) plan and roll those funds into a Roth IRA, the Roth IRA five-year holding period will apply when determining whether a subsequent distribution from the IRA is qualified. You do not get credit for any period of time the funds were in the 401(k) or 403(b) plan.*

# Roth IRA "Qualified Distributions" (Examples)

## Example 1

- Age 60 on January 1, 2019
- Establish first Roth IRA on December 31, 2019, by converting a traditional IRA to a Roth IRA
- Must have qualifying event **and** satisfy five-year holding period
- Here qualifying event has occurred — you've attained age 59½
- Five-year holding period begins January 1, 2019

- Five-year holding period ends December 31, 2023

Tax-free qualified withdrawals from this Roth IRA, and any other Roth IRA you own, are available anytime after December 31, 2023.

### Example 2

- Age 35 on January 1, 2019
- Establish first Roth IRA on June 1, 2019, by making a rollover from a 401(k) plan to a Roth IRA
- Must have qualifying event **and** satisfy five-year holding period
- Five-year holding period begins January 1, 2019
- Five-year holding period ends December 31, 2023

Tax-free qualified withdrawals from this Roth IRA, and any other Roth IRA you own, are available:

  - In 2043, after you attain age 59½
  - After December 31, 2023, if you become disabled or if you have first-time homebuyer expenses (up to $10,000 lifetime from all your IRAs)
  - After December 31, 2023, if you die

### Example 3

- You inherit a Roth IRA from your mother in 2019
- Your mother established her first Roth IRA in 2016 by making a regular annual contribution
- Must have qualifying event **and** satisfy five-year holding period
- Qualifying event is your mother's death
- Five-year holding period begins January 1, 2016
- Five-year holding period ends December 31, 2020

Tax-free qualified withdrawals from this inherited Roth IRA are available anytime after December 31, 2020.


## Nonqualified Roth Distributions

### Taxation

If you take a distribution from your Roth IRA but you haven't met the five-year holding period or there hasn't been a qualifying event, then your distribution is "nonqualified." But even nonqualified distributions from a Roth IRA get special tax treatment.

Since your own Roth contributions were made on an after-tax basis, you can withdraw those contributions tax free at any time.

Plus, you get all of your nontaxable contributions back first, before you're deemed to be withdrawing any taxable earnings. This is in contrast to

traditional IRAs, where each distribution is deemed to consist of a pro rata amount of taxable and nontaxable dollars.

Of course, any earnings you withdraw will be subject to income tax and, if you're under age 59½, the additional 10% early distribution penalty tax, unless an exception applies.

## Ordering rules

There is a special order in which contributions and earnings are considered to be distributed from your Roth IRA when you calculate the taxable portion of a nonqualified distribution. Distributions come:

- First, from regular (annual) contributions
- Second, from rollover and conversion contributions (considered distributed from earliest years first) and, within each rollover or conversion, in the following order:
  1. The taxable portion (the amount that you included in income because of the conversion or rollover)
  2. The nontaxable portion
- Finally, from earnings

In applying these ordering rules, you must aggregate all Roth IRAs you own and all distributions made in a year. You disregard excess Roth IRA contributions and related earnings, and rollover contributions that came from other Roth IRAs.

## Example

Joe converted his traditional IRA, worth $80,000, on October 15, 2015, to Roth IRA #1. At that time, Joe had no other Roth IRAs. So Joe's five-year holding period began on January 1, 2015 (the first day of the taxable year for which a Roth IRA contribution was first made by Joe). Of the $80,000 converted, $20,000 was after-tax contributions. Therefore, Joe included $60,000 in his 2015 gross income. On February 23, 2019, Joe established Roth IRA #2 by making a $6,000 regular contribution. On December 15, 2019, Joe, then age 60, took a distribution of $7,000 from Roth IRA #1.

Joe's distribution was nonqualified because it was made on December 15, 2019, which is before the end of Joe's five-year holding period (January 1, 2015, to December 31, 2019). Although Joe met one of the requirements for a qualified distribution (after the age of 59½), he did not meet the five-year-period requirement.

However, applying the Roth IRA distribution ordering rules, Joe's nonqualified distribution of $7,000 is still not taxed, since it's considered distributed from:

- Joe's regular Roth IRA contributions ($6,000), and

- Part of the $60,000 that Joe included in income at conversion ($1,000)

## Special 10% penalty recapture rule

In addition to the regular tax rules described above, if you convert traditional IRA or employer plan funds to a Roth IRA, and then take a nonqualified withdrawal within five years of the conversion, the distribution will be subject to the 10% premature distribution tax to the extent that your withdrawal consists of contributions that were taxed at the time of conversion. The reason for this special rule is to ensure that taxpayers don't convert funds from a traditional IRA or plan solely to avoid the early distribution penalty.

The five-year holding period begins on January 1 of the tax year in which you convert the funds to the Roth IRA. A separate five-year holding period applies each time you convert funds from a traditional IRA or employer plan to a Roth IRA.

***Caution:*** *This five-year period may not be the same as the five-year period used to determine whether your withdrawal is a qualified distribution.*

***Example(s):*** *In 2015, you open your first Roth IRA account by converting a fully taxable traditional IRA worth $10,000. You include $10,000 in your taxable income for 2015, and you make no further contributions. In 2018, at age 55, when the IRA is worth $12,000, you withdraw $11,000.*

The distribution is not qualified because the distribution is made before the end of the five-year holding period (December 31, 2019).

Under the ordering rules described earlier, you are considered to withdraw $10,000 of the amount you converted, and $1,000 of earnings. The earnings will be included in income and will be subject to the 10% premature distribution tax, unless an exception applies.

In addition, because you are making a nonqualified withdrawal within five years of your conversion, the $10,000 that you converted in 2015 is subject to the 10% premature distribution tax, unless an exception applies. This "recaptures" the early distribution tax you should have paid at the time of the conversion.

# Calculating the Conversion Tax

## (See 2019 Form 8606 when available)

Form **8606** | **Nondeductible IRAs** | OMB No. 1545-0074
Department of the Treasury
Internal Revenue Service (99)

► Go to *www.irs.gov/Form8606* for instructions and the latest information.

► Attach to 2018 Form 1040 or 2018 Form 1040NR.

2018
Attachment
Sequence No. **48**

Name. If married, file a separate form for each spouse required to file 2018 Form 8606. See instructions. | **Your social security number**

**Fill in Your Address Only if You Are Filing This Form by Itself and Not With Your Tax Return**

Home address (number and street, or P.O. box if mail is not delivered to your home) | Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below (see instructions). | If this is an amended return, check here ► ☐

Foreign country name | Foreign province/state/county | Foreign postal code

**Part I** **Nondeductible Contributions to Traditional IRAs and Distributions From Traditional, SEP, and SIMPLE IRAs**

Complete this part only if one or more of the following apply.

- You made nondeductible contributions to a traditional IRA for 2018.
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2018 **and** you made nondeductible contributions to a traditional IRA in 2018 or an earlier year. For this purpose, a distribution does not include a rollover (other than a repayment of a qualified 2017 disaster distribution (see 2018 Form 8915B)), qualified charitable distribution, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.
- You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2018 **and** you made nondeductible contributions to a traditional IRA in 2018 or an earlier year.

1 Enter your nondeductible contributions to traditional IRAs for 2018, including those made for 2018 from January 1, 2019, through April 15, 2019. See instructions . . . **1**

2 Enter your total basis in traditional IRAs. See instructions . . . **2**

3 Add lines 1 and 2 . . . **3**

**In 2018, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion?**
**No** ► Enter the amount from line 3 on line 14. Do not complete the rest of Part I.
**Yes** ► Go to line 4.

4 Enter those contributions included on line 1 that were made from January 1, 2019, through April 15, 2019 **4**

5 Subtract line 4 from line 3 . . . **5**

6 Enter the value of **all** your traditional, SEP, and SIMPLE IRAs as of December 31, 2018, plus any outstanding rollovers. Subtract any repayments of qualified 2017 disaster distributions (see 2018 Form 8915B). If the result is zero or less, enter -0-. See instructions . . . **6**

7 Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2018. **Do not** include rollovers (other than repayments of qualified 2017 disaster distributions (see 2018 Form 8915B)), qualified charitable distributions, a one-time distribution to fund an HSA, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see instructions) . . . **7**

8 Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2018. Also enter this amount on line 16 . . . **8**

9 Add lines 6, 7, and 8 . . . **9**

10 Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter "1.000" . . . **10** × .

11 Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17 . . . **11**

12 Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA . . . **12**

13 Add lines 11 and 12. This is the nontaxable portion of all your distributions . . . **13**

14 Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2018 and earlier years** **14**

15a Subtract line 12 from line 7 . . . **15a**

b Enter the amount on line 15a attributable to qualified 2017 disaster distributions from 2018 Form 8915B (see instructions). Also, enter this amount on 2018 Form 8915B, line 22 . . . **15b**

c **Taxable amount.** Subtract line 15b from line 15a. If more than zero, also include this amount on 2018 Form 1040, line 4b; or 2018 Form 1040NR, line 17b . . . **15c**

**Note:** You may be subject to an additional 10% tax on the amount on line 15c if you were under age 59½ at the time of the distribution. See instructions.

**For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 63966F Form **8606** (2018)

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