Roth IRAs and Conversions

When the law that created Roth IRAs was originally enacted there were two eligibility limitations placed on them. The first affected an individual's ability to contribute to a Roth by subjecting the eligibility of contributions to "income limits." This means that if an individual made over a certain amount in Modified Adjusted Gross Income (MAGI), his or her ability to contribute could be reduced or eliminated. The second limitation 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 still affect the ability to contribute new money to a Roth IRA, they no longer apply to conversion eligibility. Rules that went into effect January 1, 2010, allow virtually everyone to convert a traditional IRA or qualified retirement plan 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 $6,000 in earned income to be eligible for a $6,000 contribution).

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 72[1], 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 during the original IRA owner's lifetime.

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!

1 Individuals born before July 1, 1949 must begin RMDs at age 70 ½.

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 assets are eligible for conversion. (The SIMPLE IRA is only eligible to be converted after meeting the two-year holding period.) In addition, qualified plan distributions (such as from a 401(k), 403(b), profit sharing, or pension plan) can be converted if that distribution is otherwise eligible to be rolled over (e.g., not a Required Minimum Distribution (RMD) or hardship distribution). What's more, these qualified plan distributions can be converted directly to the Roth IRA without applying the 20% mandatory withholding otherwise required for those distributions.

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 72?
  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 during the original IRA owner's lifetime. 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 72 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, or 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 addition, a 10% penalty may apply if you withdraw conversion amounts before 5 years have elapsed since the conversion. 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[1].

Order of Distribution Taken	Age of Account Owner When Distribution is Taken	
	Under 59 ½	59 ½ or Over
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[2]	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[3]; No 10% penalty

[1] *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 Professional. Roth IRA distribution information can also be found in IRS Publication 590-B.*

[2] *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.*

[3] *The 5-year holding period generally applies based on the date of the first contribution to the Roth IRA.*

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.

Personalized Illustration

Your Oppenheimer Financial Professional 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 Professional today for assistance with your Roth IRA conversion needs!

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