

What you should know about Roth IRA conversions

One financial strategy that is often overlooked when evaluating your retirement and estate planning options is the Roth IRA conversion. Learning more about a Roth IRA conversion may be a sensible step whether you are designing a comprehensive estate plan, trying to maximize your legacy for younger family members, or seeking tax-free income opportunities in retirement.

Converting your Traditional IRA

Converting allows you to reposition your current tax-deferred Traditional IRA to a tax-free Roth IRA by paying federal and possibly state income tax (but without the IRS 10% additional tax for taking early or pre-59½ distributions [10% additional tax]) on the taxable amount of the conversion. You do not have to sell the account assets as they can be converted as an “in-kind” transfer.

Converting your qualified employer sponsored retirement plan (QRP)

You do not have to roll your QRP non-designated Roth account after-tax amounts to a Traditional IRA; instead you could choose to roll them to a Roth IRA as a conversion. A partial distribution must include a proportional share of the before- and after-tax amounts in the account. Whether you are taking a partial or full distribution of your QRP, know that you can request that the before-tax amounts be rolled to a Traditional IRA and the after-tax amounts rolled to a Roth IRA, as a conversion. This means you can:

- Elect a direct rollover of the before-tax amounts in your QRP non-designated Roth account to a Traditional IRA without any tax liability.
- Roll the after-tax non-designated Roth account amounts to a Roth IRA as a tax-free conversion.

It is important to remember that you must have a triggering event, such as separation of service, to be eligible to make distributions from your QRP. Before taking any action, ask your plan administrator if an “in-kind” transfer of assets, instead of selling, is an option if you want to continue to hold the assets when the conversion is complete.

- Convert any before-tax amounts in your QRP to a Roth IRA, owing ordinary income tax in the year of conversion.
- Have the distribution made payable to you and within 60 days decide to convert some or all of the amount to your Roth IRA.

A conversion of after-tax amounts will not be taxed. Any pre-tax portion converted will be included in your gross income for the year. Also, should you decide to convert those after-tax amounts, remember those amounts are not subject to the IRS 10% additional tax when following the Roth distribution ordering rules.

Roth IRA distribution rules

Roth IRAs have two types of distributions: qualified and non-qualified distributions. Knowing the difference will help you understand if your distribution is tax-free.

- *Qualified* distributions, which are tax-free and not included in gross income, are when your account has been open for more than five years and you are at least age 59½, or taken as a result of your death, disability, or using the first-time home buyer exception.
- A *non-qualified* distribution is one that does not meet the above requirements. Does that mean non-qualified distributions are subject to tax and the 10% additional tax? Not necessarily. Instead, non-qualified distributions follow ordering rules, discussed below. All of your Roth IRAs are aggregated when applying the distribution ordering rules.
 - **Contributions come first**—The first dollars distributed from any of your Roth IRAs, if you have several accounts, are annual contributions. Because Roth contributions are not deductible, they are not subject to tax or the 10% additional tax and can be taken at any time.
 - **Converted dollars are next**—After you have exhausted all of your contributions, the next amounts distributed are from any conversions you have completed. These conversion amounts are distributed tax-free on a first in, first out basis. Converted amounts taken before the five-year holding period, or you are 59½ or older, whichever is first, may have a 10% additional tax, unless an exception applies or when removing after-tax converted amounts. Each conversion is subject to a separate five-year holding period.

Investment and Insurance Products:

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- **Earnings are last**—The last amount is distributed from earnings. Earnings taken before your account has been open for longer than five years **and** you are at least age 59½, or for your death, disability, or using the first-time home buyer exception, are subject to tax and the 10% additional tax, unless another exception applies.
- **Exceptions to the 10% additional tax**—The exceptions include distributions after reaching age 59½, death, disability, eligible medical expenses, certain unemployed individuals' health insurance premiums, qualified first-time home buyer (\$10,000 lifetime max), qualified higher education expenses, Substantially Equal Periodic Payments (SEPP), Roth conversion, qualified reservist distribution, birth or adoption expenses (up to \$5,000), or IRS levy.

Hypothetical Roth conversion examples

Below are a couple of hypothetical examples to clarify the Roth distribution rules.

Conversion less than 5 years, owner under age 59½

Edward, age 38, has an existing Roth IRA worth \$50,000, that was first funded in 2017. \$20,000 is from Roth contributions and \$20,000 from a 2020 Roth conversion. He requests a \$25,000 distribution to pay for expenses that don't qualify for an exception to the 10% additional tax. The first \$20,000 distributed is from his contributions and is not included in gross income. The next \$5,000 taken is from the conversion, and also not included in gross income. However, he will owe the 10% additional tax on the \$5,000 because the distribution was taken prior to the five-year holding period and he is not 59½.

Conversion less than 5 years, owner over age 59½

Elena, age 60, has requested a \$25,000 distribution from her Roth IRA worth \$60,000. She opened a Roth IRA in 2018 and converted \$50,000. She has made no contributions. The \$25,000 distribution consists of converted amounts, and since she is over age 59½ she will not owe the 10% additional tax. If instead her distribution was \$60,000 she would have owed ordinary income tax, but not the 10% additional tax on the \$10,000 of earnings since she had the account for less than five years.

Benefits of a Roth conversion

Some reasons a conversion may be appropriate include:

- You are willing to pay taxes now to benefit from tax-free distributions in retirement.
- You do not have to take required minimum distributions (RMDs) during your lifetime.
- You live in a state with no income tax but will retire to a state that has income tax.
- If your spouse is the Roth IRA beneficiary, they will not have RMDs if they roll over the Roth IRA and treat it as their own.
- Beneficiaries can distribute earnings tax-free from an Inherited Roth IRA as long as the Roth had been funded for more than five years.
- Using your Roth IRA to fund your unified credit (bypass) trusts may allow the trust to be funded both income- and estate-tax free.

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Roth conversion considerations

Some reasons a conversion may not be appropriate include:

- Understanding your tax situation and ability to pay for the conversion. Because, once you convert, you can no longer recharacterize, or undo the conversion.
- Having to deplete other assets to pay the taxes due on the conversion.
- The conversion pushes you into a higher tax bracket.
- You will be in a lower tax bracket in retirement.
- You have before- and after-tax amounts in a Traditional IRA but only want to convert the after-tax because you don't want a tax burden. You cannot convert just your after-tax dollars; instead the distribution will include a proportionate amount of both. This is because of the pro-rate rule.
- You will be relocating to a state with no or lower state income tax.
- Your beneficiary is in a lower income tax bracket than you are and will inherit the Roth IRA shortly because of your illness or age.
- Your IRA beneficiary is a charity. Tax-exempt organizations will **not** owe income taxes if they inherit a Traditional IRA at your death.
- Taking a distribution from your IRA to pay the taxes due on the Roth conversion will result in additional income taxes, loss of tax deferral, and if you are under 59½, the 10% additional tax.
- RMDs cannot be converted. You must first satisfy your RMD and then complete a Roth conversion.
- You use your RMDs for day-to-day expenses. A Roth IRA needs time for potential earnings to compound tax-free to be an effective income strategy.
- The conversion income will be included when determining if your Social Security benefits are taxable.

Talk to Wells Fargo Advisors

Please contact your Financial Advisor at Wells Fargo Advisors if you want to learn more about the Roth IRA conversion. Ask for a Roth conversion illustration so you can review your options and make more informed decisions for your family's future.

With you every step of the way

Everyone has a different vision of retirement that requires a unique financial strategy. Wells Fargo Advisors can support you in your retirement planning process by providing the guidance needed to make informed choices. We will meet with you and help create a comprehensive plan that takes into account your complete financial picture. Your Financial Advisor will be with you every step of the way to meet to review your progress and adapt your plan as needed. Working together, we'll design and implement a retirement plan that can help you live out your unique vision of retirement.

