

# ROTH IRA

## Conversion Fact Sheet

Presented by Will Berigan



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The Roth conversion presents a unique opportunity for investors looking for tax-free income during retirement. All individuals, regardless of income, are allowed to convert as much or as little of their IRA and eligible employer-sponsored plan assets as they want. With some careful planning, this strategy can help maximize future retirement savings and add another layer of tax diversification to your portfolio.

### Key Features

- Contributions are made with after-tax dollars, and withdrawals of your contributions can be taken at any time, tax and penalty free.
- Earnings grow free of federal and state taxes, provided certain conditions are met.
- There are no required minimum distributions (RMDs) when the account holder reaches age 73
- Qualified distributions are tax and penalty free after five years,<sup>1</sup> provided one of the following conditions is met. The account holder:
  - Is age 59½ or older
  - Incurs a disability
  - Is a first-time homebuyer (up to \$10,000 lifetime limit)
  - Passes away
  - Uses the distributions for qualifying medical expenses or higher education

### IMPORTANT DATES TO REMEMBER

#### **December 31, 2023:**

Deadline to convert to a Roth IRA for the 2023 tax year

**April 15, 2024:** Due date for 2023 income tax return, with no extensions

### Who Can Convert to a Roth?

Any taxpayer can convert traditional, rollover, SEP, or SIMPLE IRA (after the two-year period) assets, as well as eligible employer-sponsored plan assets, to a Roth. Also, thanks to the passage of the American Taxpayer Relief Act of 2012, those with access to a qualified plan containing a Roth provision also have the opportunity to convert their contributions at any time, without the need of a triggering event. The conversion amount is reported and taxed as a distribution for the conversion year.

### The Tax Implications of Conversion

There is one very important rule to keep in mind when it comes to converting to a Roth: federal and state income taxes must be paid on any portion of the conversion that has not already been taxed.

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<sup>1</sup>Distributions are taken from the nontaxable portion first. Only when all contributions have been withdrawn will any earnings or conversion assets be distributed (subject to tax and an early withdrawal penalty, unless an exception applies).

## Roth IRA Conversion Fact Sheet *continued*

So, when considering a conversion, be sure you understand the tax implications and how you will pay the taxes incurred.

- If an account has been funded with both nondeductible and deductible contributions, federal income tax is owed on the previously untaxed amounts.
- Under the pro-rata rule, the calculation for taxes owed on the conversion is based on the ratio of nondeductible contributions to the market value of the account. For IRAs, all account balances, including SEP and SIMPLE IRAs, are aggregated, not just the account being converted. In other words, if nondeductible assets are converted from a traditional IRA to a Roth IRA, and you hold other IRAs, it is assumed that the conversion amount comes prorated from the aggregate amount of money in all of your IRAs.

### Formula for Calculating Tax-Free Amount

Nondeductible contributions ÷ total value of all IRAs = % of conversion amount that is tax free

### To Convert or Not to Convert

Because there are many factors to weigh when considering a conversion, here are several important questions to help you make a decision:

- 1. Do you want to pay taxes now or later?**
  - Income tax is owed on any taxable portion of the amount converted.
  - A Roth IRA conversion may push you into a higher tax bracket.
- 2. Do you expect that your income tax bracket will be higher at or during retirement, or do you expect tax rates to increase?**
  - If the answer is yes, it may be beneficial to do a full or partial conversion now.
  - If the answer is no, it may not be prudent to convert.
- 3. Can tax on the conversion amount be paid from a source other than the IRA?**
  - It's generally better to pay taxes with non-IRA assets because tax payments from the IRA itself could be looked at as early distributions and therefore be penalized.
  - A partial conversion may be beneficial if you cannot pay the entire tax burden.
- 4. Will you need to access the money within the next five years?**
  - Distributions taken prior to the five-year holding period may be subject to taxes and penalties.
- 5. Do you intend to leave tax-free income to beneficiaries?**
  - Because there are no RMDs beginning at age 73 with a Roth IRA, a conversion may be a good strategy for accumulating assets for future generations.
  - Heirs may receive a tax-free inheritance. (**Please note:** Depending on the circumstances, non-spouse beneficiaries will be required to take minimum distributions over their life expectancy or deplete the full balance within 10 years of the original depositor's death.)

## Other Considerations

- A Roth conversion must be executed by December 31; individuals have until the tax-filing deadline to pay taxes on the conversion.
- In the past, you could use a recharacterization to undo or reverse a previously processed Roth conversion. That is no longer the case. As of 2018, the IRS no longer allows Roth conversion contributions to be recharacterized.

*This material has been provided for general informational purposes only and does not constitute either tax or legal advice. Although we go to great lengths to make sure our information is accurate and useful, we recommend you consult a tax preparer, professional tax advisor, or lawyer.*



Will Berigan, CFP®

Shamrock Wealth Management

991 Sibley Memorial Highway | Suite 201 | Lilydale, MN 55118

651.317.4330 | 651.560.7956 fax | [www.shamrockwm.com](http://www.shamrockwm.com) | [wberigan@shamrockwm.com](mailto:wberigan@shamrockwm.com)

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