Converting Traditional IRAs to Roth IRAs

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By: Crystal Edwards, Joseph Dolan, John Elias, Charles Falk, I. Richard Ploss, Philip Siana, Deirdre Wheatley-Liss

Taxpayers who expect to have less Federal Taxable Income in 2022 might wish to consider converting a traditional IRA to a Roth IRA because the converted income will presumably be taxed at a lower rate since the taxpayer is in a lower tax bracket. While instinctively this appears to be a good strategy, caution is the rule when considering such a conversion. A series of complex rules can turn the expected results of converting a traditional IRA into a Roth IRA into a nightmare. Some considerations:

1. If you haven't had a Roth IRA for at least 5 years, your money when distributed may be subject to Federal Income Tax and/or penalties upon distribution.

2. Before converting, it is imperative that your tax preparer perform a proforma tax return estimating the “tax cost” of any conversion. The tax cost not only includes the tax resulting from converting pre-tax dollars in a traditional IRA to taxable dollars in a Roth IRA, but such conversion can result in additional taxes for other items, such as social security.

3. If your traditional IRA has both deductible and non-deductible contributions, each dollar withdrawn or converted from the traditional IRA will consist of a percentage of each type of contribution based on the ratio of each contribution in the IRA. All IRAs are aggregated for this purpose, including traditional IRAs, Simplified Employee Plans, and SIMPLE plans.

4. There are two “5-year” rules that impact a conversion of traditional IRA funds to a Roth IRA. While separate, both rules can affect a taxpayer's access to the funds that are converted. The “ordering rules” for distributions from a Roth IRA are critical in understanding the two 5-year rules. The Ordering Rules are:

- A taxpayer's contributions are distributed first;
- A taxpayer's converted dollars are distributed second;
- The earnings are distributed last.

It should be noted that “contributions” and “conversions” are not considered the same. The 5-year rules can be stated as follows:

- One 5-year rule provides that you need to have established an IRA at least 5 years ago. This rule impacts if a distribution of earnings is a “Qualified Distribution.” You only need to satisfy this rule once. A distribution of earnings after the 5-year holding period is satisfied and income tax free if the account holder is over 59.5 years of age.
- The second 5-year rule applies every time a *conversion* from a traditional IRA to a Roth IRA takes place. This rule applies if you are under 59.5 years of age and have not satisfied the 5 holding period after conversion. If you are under 59.5 years, a penalty will be applied.

5. If you plan not to access and withdraw funds from your Roth IRA after you attain the age of 59.5 years, the above rules should not affect you. However, if you are younger than 59.5 years of age and may need the converted money and earnings before you attain 59.5 years, a conversion may not be right for you. You could convert a small amount of your Traditional IRA to a Roth IRA, or establish a Roth IRA by contribution if you are under the income limits to get the once-in-a-lifetime 5 satisfied.