

How Do I? Convert from a traditional IRA to a Roth IRA?

You have carefully considered the multitude of complex tax and financial factors, run the numbers, meet the eligibility requirements, and are ready to convert your traditional IRA to a Roth IRA. The question now remains, however, how do you convert your IRA?

Conversion basics

A conversion is a penalty-free *taxable* transfer of amounts from a traditional IRA to a Roth IRA. You can convert part or all of the money in your regular IRA to a Roth. When you convert your traditional IRA to a Roth, you will have to pay income tax on the amount converted. However, a traditional IRA may be converted (or rolled over) *penalty-free* to a Roth IRA as long as you meet the requirements for conversion, including adjusted gross income (AGI) limits in effect until 2010. You should have funds outside the IRA to pay the income tax due on the conversion, rather than taking a withdrawal from your traditional IRA to pay for it - those withdrawals are subject to an early withdrawal penalty and they cannot be put back at a later time to continue to accumulate in the tax-free environment of an IRA.

Big news for 2010 and beyond

Beginning in 2010, you can convert from a traditional to a Roth IRA with no income level or filing status restrictions. For 2008, Roth IRAs are available for individuals with a maximum adjusted gross income of \$116,000 (\$169,000 for joint filers and heads of household). These income limits have prevented many individuals from establishing or converting to a Roth IRA. Not only is the income limitation eliminated after 2009, taxpayers who convert to a Roth IRA in 2010 can recognize the conversion amount in adjusted gross income (AGI) ratably over two years, in 2011 and 2012.

Example. You have \$14,000 in a traditional IRA, which consists of deductible contributions and earnings. In 2010, you convert the entire amount to a Roth IRA. You do not take any distributions in 2010. As a result of the conversion, you have \$14,000 in gross income. Unless you elect otherwise, \$7,000 of the income is included in income in 2011 and \$7,000 is included in income in 2012.

Conversion methods

There are three ways to convert your traditional IRA to a Roth. Generally, the conversion is treated as a rollover, regardless of the conversion method used. Any converted amount is treated as a distribution from the traditional IRA and a qualified rollover contribution to the Roth IRA, even if the conversion is accomplished by means of a trustee-to-trustee transfer or a transfer between IRAs of the same trustee.

1. **Rollover conversion.** Amounts distributed from a traditional IRA may be contributed (i.e. rolled over) to a Roth IRA within 60 days after the distribution.

2. **Trustee-to-trustee transfer.** Amounts in a traditional IRA may be transferred in a trustee-to-trustee transfer from the trustee of the traditional IRA to the trustee of the Roth IRA. The financial institution holding your traditional IRA assets will provide directions on how to transfer those assets to a Roth IRA that is maintained with another financial institution.

3. **Internal conversions.** Amounts in a traditional IRA may be transferred to a Roth IRA maintained by the same trustee. Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, in lieu of opening a new account or issuing a new contract. As with the trustee-to-trustee transfer, the financial institution holding the traditional IRA assets will provide instructions on how to transfer those assets to a Roth IRA. The transaction may be simpler in this instance because the transfer occurs within the same financial institution.

Failed conversions

A failed conversion has significant negative tax consequences, and generally occurs when you do not meet the Roth IRA eligibility or statutory requirements; for example, your AGI exceeds the limit in the year of conversion or you are married filing separately (note: as mentioned, the AGI limit for Roth IRAs will no longer be applicable beginning in 2010).

A failed conversion is treated as a distribution from your traditional IRA and an improper contribution to a Roth IRA. Not only will the amount of the distribution be subject to ordinary income tax in the year of the failed conversion, it will also be subject to the 10 percent early withdrawal penalty for individuals under age 59 1/2, (unless an exception applies). Moreover, the Tax Code imposes an additional 6 percent excise tax each year on the excess contribution amount made to a Roth IRA until the excess is withdrawn.

Caution - financial institutions make mistakes

The brokerage firm, bank, or other financial institution that will process your IRA to Roth IRA conversion can make mistakes, and their administrative errors will generally cost you. It is imperative that you understand the process, the paperwork, and what is required of you and your financial institution to ensure the conversion of your IRA properly and timely. Our office can apprise you of what to look out for and what to require of the financial institutions you will deal with during the process.

Determining whether to convert your traditional IRA to a Roth IRA can be a complicated decision to make, as it raises a host of tax and financial questions. Our office can help you determine not only whether conversion is right for you, but what method is best for you, too.

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