



Managing Roth and Traditional IRA Accounts

When the Roth IRA was first introduced, many investors quickly switched their retirement funding strategy from [traditional IRAs to Roth IRAs](#). Since many higher income individuals were already making after-tax contributions to an IRA, the switch to a Roth IRA made a lot of sense.

Instead of paying [federal income taxes](#) on the growth portion of their [traditional IRA's](#) after-tax contributions, investors could now make an after-tax contribution to a Roth IRA and not pay any taxes on their withdrawals in retirement.

While the benefits of the Roth were clear enough going forward, many of those planning for their retirement years didn't think twice about managing two accounts - one for their traditional IRAs and a second one for their Roth accounts. But what if they decided they wanted to convert their traditional IRA to a Roth IRA?

Roth IRA Contributions

Just to make sure we're all on the same page, let's quickly review the concept of [Roth IRA contributions](#). After all, a Roth conversion is really just one of a couple of ways that you can contribute to your [Roth IRA plan](#).

At the most basic level, anyone that has earned income and pays income taxes can contribute to a Roth IRA regardless of their age. And unlike a traditional IRA, you can still contribute to a Roth after age 70 1/2. In fact, if you want to make a contribution to a Roth IRA via a conversion, then you don't even need to have earned income. But there is an important income limitation that applies to conversions.

Roth IRA Conversion Rules

Generally, there three ways that the [IRS](#) recognizes a conversion from traditional to Roth IRAs:

Rollovers - an [IRA rollover](#) is basically an eligible distribution from a traditional IRA that is rolled-over into a Roth IRA within 60 days after the distribution.

Same Trustee Transfers - if your IRA trustee for the traditional IRA is the same trustee as the Roth IRA, then that trustee (in many cases a brokerage house) can make the account transfer on your behalf.

Trustee to Trustee Transfers - many times your traditional IRA trustee will make a transfer to your new Roth IRA trustee on your behalf - even if they are not the trustee receiving the funds.

Keep in mind that if you take a distribution from a traditional IRA, the 60-day rollover rule applies. If at all possible, you should convert your Roth IRA using a trustee-to-trustee transfer or same-trustee transfer. This keeps you clear of the 60-day rule and keeps your money working longer.

Conversion Income Limits

The IRS rules state that if you want to convert from a traditional IRA to a Roth IRA, then your [adjusted gross income or AGI](#) cannot be greater than \$100,000. This limit applies to taxpayers with filing statuses of single, head of household, and married filing jointly. If you think you can work around the \$100,000 limit by changing from married filing jointly to married filing separate returns it won't work. Married taxpayers filing separate returns are explicitly excluded from making Roth conversions.

Reversing a Roth Conversion

If you make a Roth conversion early in a calendar year and then for some reason discover that your AGI will exceed the \$100,000 threshold, then the tax law allows you "re-characterize" your Roth and have the money rolled-back into your regular IRA without a penalty. There are just a few simple steps you need to follow before you file your federal income taxes for that year.

Tax Implications of Roth Conversions

While the Roth conversion amount is NOT included in your AGI calculation to determine eligibility to convert, it may affect your AGI when calculating your income taxes owed the federal government. That's because you can contribute to a traditional IRA with both non-deductible contributions as well as tax-deductible contributions.

The rule of thumb here is pretty simple - if you've already paid federal income tax on any portion of your traditional IRA, then you don't need to include that amount again in your AGI following a conversion. Let's look at a quick example of how that would work.

Roth IRA Conversion Example

Let's say that Jon decides to convert his traditional IRA to a Roth IRA. Jon expects that his AGI will be about \$85,000 in that calendar year and he wants to convert around \$40,000 of deductible traditional IRA funds (money he has never paid federal income tax on before).

Since Jon's AGI is under the \$100,000 threshold, he can do the conversion. However, when calculating his tax liability for that year, Jon's AGI is now $\$85,000 + \$40,000$ or $\$125,000$. If Jon's incremental tax bracket is 25%, then he will need to pay an additional $25\% \times \$40,000$ or $\$10,000$ in federal income taxes the year of the conversion.

Please note that in the above example, Jon did not have to pay a 10% early withdrawal penalty on the conversion. However, with large conversions it's advisable to consult with a tax professional to see if the paying of estimated taxes is appropriate in your situation. In some states, you may also be subject to additional [state income taxes](#) on the conversion.

Paying Taxes with Converted IRA Funds

Finally, there is a common misconception that some of the converted money can be used to pay for any federal taxes owed. For example, let's say Jon doesn't have the funds to pay the \$10,000 in federal taxes owed on the conversion, so he decides to use \$10,000 of the traditional IRA money to pay federal taxes owed. If he does, this is like taking an early distribution of the money - \$10,000 in this situation. Any money not converted is subject to early withdrawal penalties - including this same money Jon wants to use to pay his federal income taxes.

About the Author - *Roth IRA Conversion*

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