

CLARIFYING SOME ROTH CONVERSION MISCONCEPTIONS

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By Andy Ives, CFP®, AIF®
IRA Analyst

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As Roth IRA conversions become more popular, questions and misconceptions abound. In no particular order, here are a dozen Roth IRA conversion facts to be aware of:

- 1.** Anyone with an IRA can do a Roth conversion. There are no income limits. You can have \$0 earned income and do a Roth conversion. You can make a million dollars and convert.
- 2.** There is no limit on the amount that can be converted. If you have an IRA worth \$3 million and want to convert the whole thing – go for it.
- 3.** Inherited (beneficiary) IRAs cannot be converted.
- 4.** There is no penalty on a Roth conversion, regardless of age. Understandably, IRA owners get a little gun-shy when they complete any transaction before the age of 59 ½. Rest assured that there is no 10% penalty on a Roth conversion, no matter how old you are.
- 5.** Beware, however, that if you are under 59 ½ and have the taxes on the conversion withheld (paid) from the IRA, there can be a 10% penalty on the amount withheld. Why? Because the taxes withheld never get converted. They are essentially an early withdrawal that is sent to the IRS. As such, it is highly recommended that if you are under 59 ½, you pay the taxes due on a Roth conversion from a source other than the IRA.

6. Speaking of the taxes – they are not due immediately upon conversion. The amount of the Roth conversion is added to your income for the year, and you can settle up with the IRS next April. (Keep an eye out for IRS Form 1099-R showing the conversion amount.)

7. Partial conversions are allowed. Implementing a strategy of partial Roth conversions specific to your financial situation can help manage taxes and mitigate risk.

8. A Roth conversion must be initiated by the end of the calendar year (December 31) to qualify for that same tax year. (The funds being converted must be withdrawn from the traditional IRA by year end.) There is no such thing as a “prior-year conversion.”

9. For IRA owners taking lifetime required minimum distributions (RMDs), i.e., they are older than 70 ½ or 72, the RMD must be taken before any Roth conversion can be done.

10. Each Roth conversion will start its own 5-year clock which must be satisfied (or you turn 59 ½) before the converted dollars can be withdrawn penalty-free. Once you have held any Roth IRA for five years and are 59 ½ or older, earnings on converted dollars can come out tax- and penalty-free.

11. Roth IRAs have favorable ordering rules for distributions. It does not matter how many Roth IRAs you have, nor does it matter if you segregate your “contributory Roth IRA” from your “conversion Roth IRA.” The IRS only sees one big bucket of Roth IRA money under your name. Regardless of which Roth IRA you take a distribution from, Roth ordering rules dictate that contributions come out first, then converted dollars, then earnings.

12. Be careful! Roth conversions are added to adjusted gross income (AGI). This can impact “stealth taxes” on items tied to AGI such as IRMAA surcharges, financial aid, and taxability of Social Security.

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