# Gaining the benefits of a Roth IRA with a Roth conversion

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With tax and legislative environments constantly changing, it can be as important to have diversification in your retirement account types as it is to have diversification in your investment portfolio. Often that diversification is achieved through contributions to retirement accounts with different tax treatments, although it can also be achieved through a Roth conversion. A Roth conversion involves moving funds from a traditional individual retirement account (IRA) to a Roth IRA. With a Roth conversion, you pay taxes now to convert your funds, but you can gain access to tax-free distributions in the future, as well as other benefits Roth IRAs offer.

**Tax treatment of retirement accounts**

| | Traditional IRA | Roth IRA |
|---|---|---|
| Contributions | Generally no income taxes | **Income taxes apply** |
| Earnings growth (within account) | Tax deferred | Generally tax free |
| Distributions | **Income taxes apply** | Generally tax free |
| Impact on taxable income | **Increases, potentially increasing Social Security tax and Medicare premiums** | Generally none |

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## The benefits of Roth IRAs

To start, let's touch on the many benefits of Roth IRAs: tax-free income in retirement (giving you greater control over your taxes in retirement), no required minimum distributions (RMDs), a tax-free asset for your heirs and the ability to access contributions tax- and penalty-free before retirement.

Many people gain access to these benefits by making regular contributions to a Roth IRA, but regular contributions to a Roth IRA are subject to income limits, leaving some unable to contribute directly. Additionally, Roth accounts are much newer than traditional retirement accounts, so those who have been saving for a long time may not have had as much opportunity to contribute to them.

## The benefits of Roth conversions

A Roth conversion is a way to fund a Roth IRA for those who either can't contribute to a Roth IRA or don't have the opportunity to do so — at the cost of paying taxes now.

While there can be benefits to completing a Roth conversion, it can have a significant impact on your current and future taxes. Because of this, it's important to consult with your tax professional to determine how it will affect your tax situation before completing a Roth conversion.

## When should you consider a Roth conversion?

When you:

- Don't need access to the funds for five years AND
- Are willing and able to pay any related taxes from sources other than your conversion AND
- Meet one or more of the following:
  - You have a sizable amount of assets in traditional retirement accounts, but you want access to tax-free assets or to reduce RMDs in the future.
  - You expect your future tax bracket to be higher than it currently is.
  - Your taxable income is likely to be high in retirement (one of the top four federal tax brackets).
  - You want to pass tax-free assets to your heirs.

**It's worth noting that once you convert funds from a traditional IRA, you can't undo or reverse the transaction.**

## Correcting common misconceptions

There are common misconceptions about the ability to do a Roth conversion. Here are the facts:

- They are not limited by the amount of your income. While income can limit your ability to contribute directly to a Roth IRA, it does not limit your ability to do a Roth conversion.
- You are not limited in the number of times you can do a Roth conversion, so you can choose to do them in smaller amounts over multiple tax years to avoid triggering additional taxes.
- You can do Roth conversions at any age. However, if you're enrolled or within two tax years of enrolling in Medicare (turning 63 or older for most people), consider whether a Roth conversion will affect Medicare premium surcharges, known as the income-related monthly adjustment amount (IRMAA). See our report, *Medicare and IRMAA: Higher income can lead to Medicare premium surcharges*, for more information.

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## How Roth IRA conversions are taxed

A question that often gets asked is, "Will I owe taxes on a Roth conversion?" While there are situations in which you may not owe taxes, for most people there are likely to be taxes owed on the conversion. Most people receive a tax deduction when contributing to a traditional retirement account, so to get the benefit of future tax-free withdrawals, they must pay taxes on those funds when converting them to a Roth.

If all the funds in your IRA(s) received a tax deduction (which is common), you will owe taxes on the full amount of the conversion. If you have a mix of pretax and after-tax dollars in your IRA(s), the amount that's taxed is based on the percentage of your IRA(s) that is made up of pretax amounts. This is known as the Pro-Rata Rule.

In addition, it's important to note that the IRS looks at all your traditional IRAs (SEP and SIMPLE included) when determining your allocation of pretax and after-tax dollars. This is known as the Aggregation Rule. Therefore, even if you are converting funds from an IRA that does not have pretax money in it, you will still owe some taxes on the converted amount if you have another IRA with pretax assets.

An example can sometimes help: Jeff has a traditional IRA worth $600,000 that includes $100,000 of after-tax contributions. He has another traditional IRA valued at $400,000 that includes pretax dollars only. He would like to convert $100,000 to a Roth IRA.

To determine how much of the conversion is subject to taxes, Jeff must determine what percentage of his combined IRA assets are pretax. In this case, 90% of his IRA assets are pretax and 10% of his assets are after-tax. (It's worth noting that earnings are treated as pretax amounts, even if they were on after-tax contributions.) As a result, he will owe taxes on 90% of the conversion amount, or $90,000, and 10% will be tax-free.

While there are a couple of exceptions that can allow you to separate your pretax and after-tax contributions, generally you cannot. Some refer to this as the cream-in-the-coffee rule, because like mixing cream into coffee, once pretax and after-tax amounts are mixed, they generally are not able to be separated.

### Separating the cream from the coffee

While you generally can't avoid the Pro-Rata Rule, there are a couple exceptions that allow you to separate the cream from the coffee, which is known as isolating basis in an IRA.

- ***Rolling funds into a 401(k) or another eligible employer plan:*** Some 401(k) plans allow you to roll funds from a traditional IRA into a 401(k), which is sometimes called a reverse rollover. Because only pretax funds can be rolled into an employer plan, this strategy effectively allows you to isolate the basis (or after-tax portion) of the IRA. You can then convert the remaining after-tax contributions to a Roth IRA without an associated tax bill. Before executing this strategy, there are some things you should be aware of. If you would like to roll your funds back out of your 401(k) after you convert your after-tax dollars, your plan might not let you do so until after you leave your employer, so make sure to check the rules of your plan. Also, make sure to wait until the year after your Roth conversion to roll the funds back out; otherwise, the pretax funds are counted as part of the Pro-Rata Rule, since your pro-rata allocation is based on your end-of-year balances.
- ***Qualified charitable distributions (QCDs):*** A QCD is a distribution taken directly from an IRA and donated to a qualified charitable organization. Because QCDs are only made with pretax funds, your remaining after-tax contributions make up a larger portion of the account. You must be 70½ or older to use this strategy, and it's also important to note that you are giving your assets away to a charity. However, if charitable giving is one of your goals, a QCD offers additional benefits besides isolating basis — it can satisfy your RMD, and you can exclude up to $108,000 (in 2025, indexed annually) from your taxable income each year.

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## Strategies for managing your conversion taxes

*Partial Roth conversions*

Because you're not limited in the number of times you can complete a Roth conversion, it often makes sense to convert part of your IRA rather than the entire account. By executing Roth conversions in smaller pieces, you can avoid concentrating the tax bill in any one year. And if you have years when your income is lower, you can opportunistically use those years to avoid a bump in your tax bracket.

*Timing your conversion*

It can be helpful to wait until later in the year to make a Roth conversion. This is because you're likely to have a better sense of your taxable income later in the year, helping you coordinate the size of your Roth conversion appropriately. Another reason to wait until later in the year is because the Pro-Rata Rule is based on your end-of-year balance, so you likely won't know the exact allocation of pretax and after-tax dollars at the time of conversion. Therefore, waiting until year-end can give you a better idea of how much of your conversion is subject to taxes.

While it's generally a good idea to wait until the end of the year to complete a Roth conversion, converting earlier in the year if markets are down can be beneficial, especially if you have a good sense of your taxable income for the year. By doing so, you can either convert the same amount of shares with a smaller tax bill or convert more of the underlying investments for what otherwise would have been the same tax bill.

*Paying for the taxes*

If you do end up needing to pay taxes for your Roth conversion, it's generally a good idea to pay for the taxes out of pocket (rather than having them withheld). Otherwise, you'll end up with less converted into your Roth and miss the potential tax-free growth on those withheld funds, and you could owe a penalty on the withheld amount. Depending on the size of your Roth conversion, you may want to consider paying estimated taxes upon completing the conversion. This may help you avoid an underpayment penalty if you wait until the tax-filing deadline to pay your taxes.

### Can you convert an RMD?

No, it's very important to take any RMDs first and then do your Roth conversion. Failing to do so can result in a penalty of up to 25% of the required RMD.



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## How distributions from a Roth IRA are taxed

Before converting, it's important to understand how distributions are taxed when withdrawing funds from a Roth IRA. Roth IRAs generally have favorable distribution rules that can help limit the taxes and penalties you pay on a distribution if you have to pay them at all. When a distribution is taken from a Roth IRA, the funds are distributed in the following order:

1. ***Regular contributions:*** Can be distributed anytime without taxes or penalties.
2. ***Taxable conversion contributions (oldest first):*** Distributions won't be taxed but may be subject to penalties. Additional details follow.
3. ***Non-taxable conversion contributions (oldest first):*** Distributions not subject to penalties or taxes.
4. ***Earnings:*** Distributions may be subject to taxes and penalties. Additional details follow.

### *Taxable conversion contributions*

Taxable conversion contributions are not subject to taxes when distributed, because they were taxed when converted. The distribution is subject to the 10% penalty if you have not met the five-year holding period requirement, are younger than 59½ and do not qualify for a penalty exception.

### *Earnings*

To avoid taxes and the 10% penalty on a distribution of earnings, you need to satisfy two requirements:

1. The distribution must be made after the owner turns 59½, dies or becomes disabled, or for a qualified first-time home purchase (up to $10,000).
2. You must meet the five-year holding period requirement.

If you don't meet those requirements, you can still avoid the 10% penalty if you qualify for an exception, but the distribution is subject to taxes if you don't meet the two criteria listed earlier in this section.

### *The five-year holding period requirement*

When satisfying the five-year holding period requirement, you should be aware that distributions of Roth earnings and taxable conversions contributions are treated differently. The five-year requirement for earnings starts the first year you fund any Roth IRA (your earliest-funded Roth IRA satisfies this for all your Roth IRAs), and once the requirement is satisfied for earnings, it's always satisfied. So, if you made a 2024 Roth contribution on April 14, 2025, your holding period requirement would be satisfied on Jan. 1, 2029.

Taxable conversion contributions are different. If you're younger than 59½ and don't qualify for a penalty exception, you must meet the holding period requirement for each conversion you complete. For example, let's say you make a conversion in 2024 and another conversion in 2025. Your conversion amounts from the 2024 conversion can be withdrawn on Jan. 1, 2029, penalty free. The conversion amounts from your 2025 conversion can be withdrawn on Jan. 1, 2030, penalty free.

The deadline for a Roth conversion is also different. While the deadline for an IRA contribution to count for a tax year is the tax deadline (typically April 15 of the following year), the deadline for a conversion counting for a given year is Dec. 31.

## Roth conversions: A strategy worth considering

Roth conversions are one way to get the many benefits of Roth accounts, including providing flexibility and control over your taxes in retirement. Talk with your financial advisor today about whether it may fit within your financial strategy.

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