

# TaxBrief

Keeping you informed

## Rollover IRAs and Roth conversions

When you leave a job or look to optimize your retirement strategy, what you do with your retirement savings can significantly affect your future income and your tax bills. If you roll over a 401(k) or other qualified plan into an IRA, the account maintains its tax-deferred growth and often gives you more investment options. For some, the next move could be converting that traditional IRA to a Roth IRA, creating a powerful opportunity for tax-free income in retirement.

But these strategies involve complex rules and potential pitfalls. In this newsletter, we'll break down everything you need to know about rollover IRAs, Roth conversions and how to avoid costly mistakes.

### What is a rollover IRA?

A rollover is a type of individual retirement account that allows you to move money from a certain retirement plan like a §401(k) into an IRA without paying taxes or penalties at the time of the transfer. It helps keep your retirement savings growing tax deferred.

A rollover IRA is an IRA account that receives assets (generally cash, sometimes stocks) from an eligible retirement plan, such as a:

- 401(k)
- 403(b)
- 457(b)
- Another IRA

### Benefits of a rollover IRA

- **Keep tax-deferred growth:** Rolling assets directly into an IRA avoids immediate taxation and early withdrawal penalties.
- **More investment choices:** IRAs typically offer more investment options than workplace plans.

- **Simplify your accounts:** Consolidating retirement assets into one IRA makes it easier to manage your portfolio.
- **Flexibility:** IRAs often provide better beneficiary designation options and distribution strategies.

### Direct vs. indirect rollovers

Understanding how you move your funds is critical. This may be something you'll have to do when you leave one employer and do not have another employer to move your retirement account to just yet. You'll need to decide where your funds go when you leave that employer. There are two types of rollovers:

- **Direct rollover:** This is the best option for tax purposes. Your old retirement plan (say from a previous employer) sends funds directly to your new IRA custodian. No taxes are withheld, and you avoid penalties.
- **Indirect rollover:** Funds from your previous retirement account are distributed to you first. You must deposit the entire amount into your IRA within 60 days. The plan administrator (from your previous employer) is required to withhold 20% for taxes, which you'll need to make up from other funds (say from your own cash or savings account) to complete a full rollover.

**Example:** If you roll over \$100,000 indirectly, the plan may send you \$80,000 after withholding 20%. To avoid a taxable distribution on the \$20,000 withheld, you must deposit \$100,000 in total to your IRA within 60 days.

### The 60-day rule

If you do an **indirect rollover**, you have precisely 60 days from the day you receive the funds to deposit them into a rollover IRA. Missing this deadline means the IRS considers the amount withdrawn as

taxable income, and you'll also have to pay a 10% penalty if you're under 59½.

## Once-per-year rollover rule

Indirect rollovers are subject to the IRS's once-per-12-month rule. No matter how many IRAs you own, you can only do one IRA-to-IRA rollover in any 12-month period. Violating this rule can lead to immediate taxation of the rollover amount and possible penalties. This rule doesn't apply to direct rollovers from employer plans or trustee-to-trustee transfers between IRAs.

## Traditional IRA to Roth IRA conversions

A Roth conversion moves money from a traditional IRA or other pre-tax retirement account into a Roth IRA. Once converted, your funds grow tax-free, and qualified withdrawals are tax-free in retirement. Unlike Roth contributions, Roth conversions have no income limits, meaning anyone can use them to move pre-tax assets into a Roth IRA.

### Benefits of Roth conversions

- **Tax-free retirement income:** After satisfying Roth IRA rules (five-year holding period and age 59½), withdrawals are tax-free.
- **No RMDs:** Roth IRAs don't require minimum distributions during the owner's lifetime, unlike traditional IRAs.
- **Tax diversification:** Conversions allow you to build a mix of taxable, tax-deferred and tax-free income sources.
- **Estate planning advantages:** Heirs can benefit from tax-free distributions.

### Tax impact

When you convert pre-tax assets to a Roth IRA, you must pay ordinary income tax on the amount converted. This means converting large balances in one year can push you into a higher tax bracket. Consider converting smaller amounts to help manage your tax bracket.

**Example:** If you convert \$100,000 from a traditional IRA, that \$100,000 is added to your taxable income in the year of conversion.

## Roth conversion strategies

- **Convert during lower-income years:** Convert in low-income years: Time conversions during lower-tax-bracket periods, such as early retirement before Social Security or pension income starts.
- **Bracket management:** Convert just enough each year to stay within your desired tax bracket.
- **Partial conversions:** Spread conversions over multiple years to avoid large tax spikes.
- **Pay taxes with outside funds:** Using cash from savings to pay the conversion tax bill preserves more assets inside the Roth for tax-free growth.

## The five-year rule for Roth conversions

Roth conversion strategies involve moving money from a traditional retirement account (IRA) to a Roth IRA. You pay taxes now on the amount you convert, but once it's in the Roth, it grows tax-free and can be withdrawn tax-free in retirement. This can be a smart move if you expect higher taxes in the future or want to reduce your tax liability later in life.

Each Roth conversion has its own five-year clock to avoid the 10% penalty on early withdrawals of converted funds (principal only). This is separate from the five-year rule for tax-free earnings withdrawals on Roth contributions.

- If you withdraw converted amounts before five years and are under age 59½, you may owe a 10% penalty.
- The clock starts on Jan. 1 of the year of conversion.

## Backdoor Roth IRAs

Due to income limits, high-income earners often can't contribute directly to a Roth IRA. A backdoor Roth involves making a nondeductible contribution to a traditional IRA and immediately converting it to a Roth IRA.

**Caution:** The pro-rata rule applies if you have other pre-tax IRAs, potentially making part of your conversion taxable even if you used non-deductible contributions.

## Common pitfalls to avoid

- **Missing the 60-day deadline:** Results in taxable income and possible penalties.
- **Rolling over required minimum distributions (RMDs):** Once you reach RMD age, you can't roll your RMD amount into an IRA.
- **Not understanding the pro-rata rule:** If you have other pre-tax IRA assets, your Roth conversion will be proportionally taxable based on all your IRAs combined.
- **Underestimating tax liability:** A large conversion can unexpectedly push you into a higher tax bracket, increase Medicare premiums or impact taxation of Social Security.

## Special considerations for rollovers

- If you leave your employer after age 55, taking distributions directly from a 401(k) avoids the 10% penalty. Rolling those funds to an IRA eliminates this early withdrawal exception.
- Roth 401(k) balances can be rolled to a Roth IRA tax-free, maintaining their tax-free growth and avoiding RMDs in retirement.
- Some employer plans include after-tax contributions. Rolling these properly can let you separate pre-tax and after-tax amounts, converting after-tax dollars to a Roth IRA tax-free.

## Plan carefully, reap the benefits

Rollover IRAs and Roth conversions are powerful strategies for retirement planning, but executing them properly is critical. Missteps can cause unexpected taxes, penalties or missed opportunities.

## Your next steps

- Review your retirement accounts before changing jobs or retiring.
- Book a meeting with me and together, we can plan Roth conversions or backdoor Roth tailored to your income, goals and tax bracket.
- Keep careful records of rollovers and conversions for future tax reporting.