In 1997, Congress introduced Roth IRAs, giving investors a new product for retirement savings. Roth IRAs are essentially a mirror image of Traditional IRAs, but with a few important differences. Unlike Traditional IRAs, Roth IRA contributions are not tax deductible, so taxpayers investing in a Roth must recognize income in the contribution year. Additionally, qualified withdrawals from Roth IRAs are generally income tax free — a big advantage when compared with Traditional IRAs where qualified withdrawals are subject to ordinary income taxes.

Since the inception of Roth IRAs, Roth plans have grown in popularity in recent years due to several tax law changes. Specifically, in 2006, Congress introduced Roth 401(k) and 403(b) plans — which combine the features of Roth IRAs and 401(k)/403(b) accounts. Additionally, beginning in 2010, essentially all taxpayers became eligible to convert to a Roth IRA through the lifting of the taxable income limitations that had been in place since the inception of the Roth IRA. Near the end of 2010, participants in a 401(k) or 403(b) plan became eligible to do an “in-plan” conversion (if allowed under the participant’s plan) wherein the participant can convert pretax amounts into after-tax Roth amounts in the same plan. Finally, beginning in 2011, the same bill that allowed for “in-plan” conversions also allows government 457(b) plans to treat elective deferrals as Roth contributions.

What is a Roth conversion?
A Roth conversion is done by converting or rolling over an existing Traditional IRA and/or tax qualified plan (e.g., 401(k), 403(b) or 457) into a Roth plan. The income tax free withdrawals that Roth plans offer make them an attractive investment option. However, there are significant tax implications to doing a Roth conversion. If you’re eligible, you should decide whether it is advisable for you to convert.

Eligibility requirements for conversions
Beginning in 2010, the income limitation that had historically prevented many individuals from converting to a Roth plan was removed. This means that essentially everyone is now eligible to convert.

If, however, you inherit an IRA from someone other than your spouse, the IRA does not qualify for conversion; an inherited account from a spouse only qualifies for conversion if you first elect to treat it as your own IRA and then convert it. A non-spouse beneficiary can convert an inherited Traditional retirement plan such as a 401(k) or 403(b) to an inherited Roth IRA, provided the beneficiary meets the definition of a designated beneficiary for minimum distribution purposes and is otherwise eligible to convert.

Advantages of a Roth conversion
The primary advantage of a Roth plan is that the asset growth, dividends and interest within it are not taxable while assets are held in the plan. However, when you withdraw assets from the Roth plan, the distributions are income tax free under certain conditions.
An analysis of Roth conversions

Roth conversions offer other potential advantages including:

- Lifetime minimum distribution rules, which generally require you to begin taking distributions from Traditional retirement plans starting at age 70½, do not apply to Roth IRAs. In fact, with Roth IRAs, there is no required beginning date at which you must begin distributions. Therefore, while required distributions will eventually diminish the amount of funds in a Traditional IRA, Roth IRAs have the potential to keep growing larger over your lifetime. Please note, however, that the same is not true with a Roth 401(k)/403(b) plan, which is subject to the same lifetime required minimum distribution rules as its Traditional counterpart. For this reason, a participant in a Roth 401(k)/403(b) plan nearing age 70½ should consider rolling over the Roth 401(k)/403(b) plan into a Roth IRA to avoid lifetime required minimum distributions. Upon death, minimum distribution rules do apply to the named beneficiary of a Roth IRA and Roth 401(k)/403(b) plan, although qualified distributions to the beneficiary continue to be income tax free.

- There is no maximum age for contributing to a Roth IRA. In contrast, the maximum age for a Traditional IRA is 70½. (When investing in either a Roth IRA or a Traditional IRA, the maximum regular contribution for the 2011 and 2012 tax year is $5,000 of earned income, or $6,000 if you are age 50 or older.)

- There is tax diversity among your retirement plans, which means that having both a Traditional plan and a Roth plan allows you to control how much cash flow comes from pretax and after-tax sources during your retirement. This flexibility can help you if you are balancing between two tax brackets.

- Roth conversions are generally risk free in the short term. This is because you typically have until April 15 or October 15 if you timely file (i.e., to file your income tax return or an extension by the respective IRS deadlines) of the year after you convert to switch back or “recharacterize” to a Traditional plan.

Issues to consider before converting

Roth conversions are taxable

A Roth conversion is a taxable event, which means that the converted amount is included in your gross income in the year you convert (except to the extent it represents a return of any nondeductible contributions). For tax purposes, the IRS treats all IRAs as a single IRA, even when the IRA consists of deductible and nondeductible contributions. Therefore, there is no advantage in taking a distribution from the IRA with the greatest nondeductible contributions. Please note that you cannot convert only the nontaxable portion of the plan. Roth 401(k)/403(b) plans are different, however, in that these plans are not aggregated for purposes of determining the deductible and nondeductible contributions. Therefore, it is possible to convert the plan that holds only nondeductible or after-tax contributions.

There is no limit on the amount you can convert to a Roth plan. There is also generally no limit on the number of times you can convert from multiple plans or a single plan in the same year. Partial conversions to a Roth plan are permitted. For example, if you have multiple Traditional IRAs, you can convert one or more of them. Or, if you have a single Traditional IRA, you can choose to convert only a portion of it. Doing a partial conversion may make sense if you are concerned that converting the entire plan will push you into a higher tax bracket. Please note, however, that same
An analysis of Roth conversions

Year reconversions are not allowed, which means that you cannot recharacterize from a Roth plan to a Traditional IRA and then reconvert it to a Roth plan again in the same taxable year.

**Payment of tax on conversion**

The IRS treats a conversion from a Traditional plan to a Roth plan as a distribution. Thus, the conversion amount is included in your gross income and is taxable, similar to how an actual distribution of the same amount from your Traditional plan would be taxable. You will pay tax on the converted amount at your applicable tax rate.

If you are younger than age 59½, you will likely incur a 10% penalty on any portion of the converted plan that you use to pay the income tax liability and/or on any portion of the plan withdrawn for other reasons after the conversion. Therefore, if you are younger than 59½, it is generally suggested that you do a conversion only if you have adequate nonqualified (i.e., after-tax) assets available to pay the income tax liability. There are exceptions to this penalty tax if you are disabled or buying a first home.⁶

If you are older than 59½, you can pay the tax from the converted assets without penalty. In such cases, carefully review your strategy because the tax payment from the Roth reduces the plan’s size, resulting in fewer assets available to grow tax deferred in the Roth plan. Furthermore, you must be willing to abide by the five-year period (see the “Rules governing distributions” section on page 4).

Additionally, if you plan to pay the tax from nonqualified (i.e., after-tax) assets rather than from the converted assets, consider whether you will incur significant capital gains when raising the cash. Taxation of the converted amount, combined with the capital gains taxation, could result in you having to pay more tax now than your beneficiary would have to pay upon your death if you had left the assets in the Traditional plan. This is because nonqualified assets generally receive a step-up in cost basis upon your death, thereby eliminating any capital gains tax.

**Income tax rates**

If you expect to be in a lower income tax bracket in the future, it might be more beneficial to keep your assets in the Traditional plan for now. But if you expect to be in a higher income tax bracket in the future, there may be a greater benefit to converting.

You should also consider the projected income tax brackets for your named beneficiary, particularly if you don’t require all of the converted assets for your support during your lifetime. If you expect your beneficiary to be in a lower income tax bracket than you, then you may see more benefit in keeping your assets in the Traditional plan and allowing the beneficiary to recognize the tax upon your death. In this situation, your beneficiary generally has substantial flexibility to “stretch out” distributions from the Traditional plan.⁶ Another planning strategy is to think about making any charitable contributions during the conversion year to lessen potential income tax implications.

**Investment performance**

Pay attention to the financial markets. You do not want to pay federal and state tax now on the conversion of a Traditional plan only to see the converted account’s value decrease later.
An analysis of Roth conversions

Beneficiary considerations

If your individual beneficiary (or a trust you established for the beneficiary) is in a higher income tax bracket than you, a conversion might make sense. This is especially true if you don’t need to draw upon the plan during your life and can pay the income tax liability from other assets. Also, if you wish to leave a plan to a noncitizen spouse or to a trust for a special-needs child, a conversion might be a good strategy because it removes income tax considerations from the equation.

Please note that an inherited Roth plan is generally not protected from a beneficiary’s creditors. If your beneficiary has professional liability concerns from a divorce, a disability or credit issues, then consider establishing a qualified trust for this person’s benefit, which includes spendthrift trust provisions, for asset protection purposes.

Rules governing distributions

In the event you need access to the converted funds in the short term, be aware of the rules governing Roth distributions. Specifically, in order to make a qualified distribution, you need to satisfy the following:

- You must be at least 59½ years of age or qualify for one of the exceptions to receive a qualified distribution.\(^7\)
- You cannot take a distribution from a Roth plan for at least five years after the conversion. Under this five-year period rule, you must generally wait at least five years from the first day of the tax year in which you made the conversion before you can take a qualified distribution.

If you have multiple Roth IRAs, each account is governed by the same five-year period.\(^8\) However, if you have multiple employer plans – e.g., a Roth 401(k) and a Roth 403(b) – each plan is governed by a separate five-year rule. The only exception is if you make a direct transfer from one employer plan to another, in which case the starting date for whichever account is older applies; this exception only applies to direct transfers and not to rollovers.

Conclusion

It is critical that you work with a qualified attorney or tax advisor and that you continue to obtain input from your TIAA-CREF Advisor to develop a fundamental understanding of the Roth conversion strategy and how it may apply to your specific circumstances.
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1 Distributions from tax-qualified retirement plans — including 401(k) plans, tax-sheltered annuities (section 403(b) plans), and governmental 457 plans — are candidates for conversion. You can also convert a Simple IRA, but only after you participate in the Simple IRA plan for at least two years.

2 See the Tax Increase Prevention and Reconciliation Act.

3 Distributions from a Roth IRA cannot be used to fulfill a minimum distribution requirement arising from a Traditional retirement plan account.

4 If you do a Roth conversion and decide you are unhappy about it, or if you discover that you were not eligible to convert, you can “recharacterize” the conversion. This recharacterization must be made on a “trustee-to-trustee” basis instead of by rollover, the original contribution and net income must be transferred back, and irrevocable notice must be given to the plan trustee. You generally cannot do a reconversion until the latter of: 1) the taxable year following the taxable year of the original conversion, or 2) 30 days after the switch back.

5 Since you already paid the appropriate tax on the original conversion amount for the calendar year in which you converted the asset, the tax and penalty amount is generally imposed upon the earnings rather than upon the original conversion amount.

6 Most 403(b)s, 457(b)s and IRAs permit beneficiaries to use their own ages to determine the applicable divisor. Sometimes called “stretch-out” planning, this strategy gives the beneficiaries of inherited plans the flexibility to achieve maximum compound tax deferral inside the plan. When considering stretch-out planning, it’s important to tailor the beneficiary designation forms carefully. Since IRS regulations can be complex, consider using the services of an attorney or tax advisor. Also, check with your plan administrator to make sure that stretch-out planning is available under your plan.

7 There is an exception for a disability, your death, or if you qualify as a first-time home buyer.

8 Generally the five-year period for all of a participant’s Roth IRAs begins on January 1 of the first year for which a contribution or conversion was made to any Roth IRA maintained for that participant. There is an exception, however; if the participant is under the age of 59½ at the time of conversion and remains under the age of 59½ at the time of distribution from the converted funds, the five-year period begins January 1 of the first year for which that particular conversion (from which the converted funds are withdrawn) occurred.

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