WELLS FARGO Advisors

Roth IRA conversion overview

One financial strategy that is often overlooked when evaluating your retirement and estate planning options is the Roth IRA conversion. Converting allows you to reposition your current tax-deferred retirement account to a Roth IRA by paying federal and possibly state income tax [but without the IRS 10% additional tax for taking early or pre-59½ distributions (10% additional tax)] on the taxable amount of the conversion. The benefit is that any earnings would be distributed tax-free, if certain conditions are met.

Why convert to a Roth IRA?

Roth IRAs have some potential advantages over Traditional IRAs. Traditional IRAs allow for tax-deferred growth potential of retirement assets with taxes being due when distributions are taken. Distributions of Roth IRA earnings are tax-free, as long as the Roth has been open for more than five years and you are at least age 59½ or as a result of your death, disability, or using the first-time homebuyer exception.

A conversion to a Roth IRA triggers income tax due on the taxable amount converted. So, does it make sense to pay taxes now on your IRA? Here are some reasons why it might.

- Tax diversification potential. Tax-free distributions allow for more flexibility to manage taxable income in retirement.
- You are expecting to be in a higher tax bracket in the future. If so, then paying taxes now at a lower rate may be wise.
- You live in a state without state income tax so you will owe less tax on the conversion.
- You have money outside of the IRA to pay the taxes.
- No required minimum distributions (RMDs) during your lifetime.
- Generally tax-free distributions for beneficiaries, a feature which supports important estate planning options.

Why not convert?

While Roth conversions can provide the potential for favorable tax treatment, they are not for everyone. When determining whether a conversion is appropriate for your situation, consider if:

- A conversion could push you into a higher tax bracket.
- You have the ability to pay for the conversion and what your tax situation may be like. Because, once you convert, you cannot recharacterize, or undo the conversion.
- The income generated by the conversion may increase your modified adjusted gross income (MAGI). This could reduce or eliminate certain tax credits or deductions you were eligible for, as well as subject you to a 3.8% Medicare surtax.
- You expect to be in a lower tax bracket in retirement.
- The state you live in now imposes income tax on retirement account distributions and if you will reside in a state with lower or no income tax in the future.
- Within the next five years you will need to access the converted Roth funds.
- You do not have funds outside of your retirement accounts to pay the taxes on the conversion.
- You will leave your IRA to a charity.

What types of retirement accounts can I convert to a Roth IRA?

Most retirement plans are eligible to be converted to a Roth IRA. The table below outlines the plan types and also the Roth conversion options beneficiaries have when inheriting retirement plan assets.

Eligible plans and beneficiary options		
Types of plans eligible to convert to a Roth IRA:	**Yes**	**No**
401(k), 403(b), governmental 457(b) plans (a triggering event, such as leaving the company you work for, is required to distribute or convert from plan)	X	
Traditional, SEP & (after 2 years) SIMPLE IRAs	X	
Beneficiary conversion options:		
Spouse inheriting a Traditional, SEP, or SIMPLE IRA and converting to own IRA	X	
Spouse or Non-spouse inheriting 401(k), 403(b), or governmental 457(b). Non-spouse can only convert to an Inherited Roth IRA. Spouse can convert to either Inherited Roth IRA or own Roth IRA.	X	
Non-spouse inheriting a Traditional, SEP, or SIMPLE IRA		X

Roth conversions need to be completed by 12/31 of the year.

Hope's hypothetical examples

Hope is age 43 and is planning to retire in 20 years. She is in the 24% tax bracket and has $25,000 in a Traditional IRA that is fully taxable. Hope believes her tax bracket will increase, so she is considering converting her Traditional IRA to a Roth IRA paying the associated taxes. We will illustrate four scenarios — two scenarios showing if Hope converts, how she will choose to pay her taxes, and two scenarios where she does not convert; instead, she pays taxes in retirement at either the 24% or 32% tax rate. We will also assume she has a savings account worth $6,600 that is available to pay for the taxes due on the conversion for all scenarios.

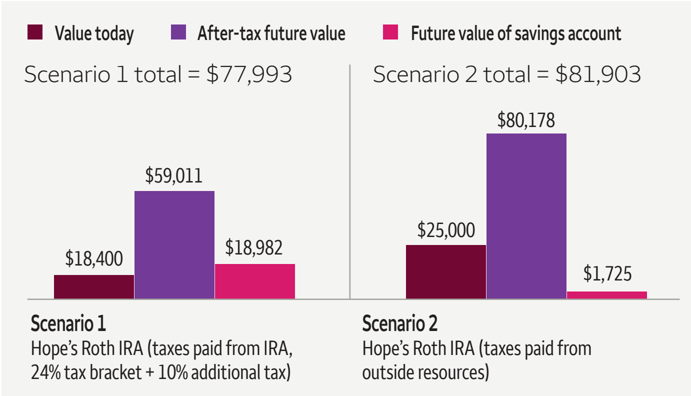
- **Scenario 1** — Hope will pay the taxes due at a 24% tax rate on the $25,000 from her Traditional IRA. She will also owe an additional 10% tax on her $6,000 liability since she is under 59½ making the grand total $6,600. This will leave less to convert to the Roth IRA.
- **Scenario 2** — The taxes will be paid from a taxable account and the full $25,000 will be converted to Hope's Roth IRA. Since the taxes were paid from savings, there is no 10% additional tax due. That money will instead be invested in the savings account.
- **Scenario 3** — Hope chooses not to convert even though she might be in a higher tax bracket in retirement. She will invest the $6,600 that she would have used to pay the taxes if she completed a Roth conversion, in a taxable account.
- **Scenario 4** — Hope chooses not to convert. She thinks she could be in the same tax bracket in retirement, and will invest the $6,600 that she would have used to pay the taxes if she completed a Roth conversion, in a taxable account.

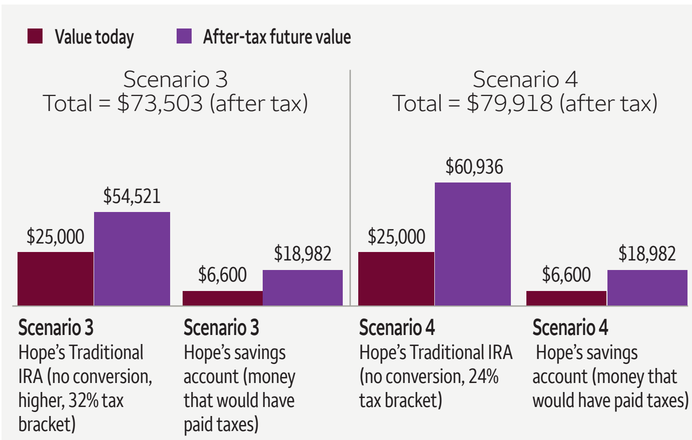
What will the after-tax values of those accounts be like in 20 years? You can see the results in the chart on the next page.

- In scenario 1, Hope's Roth IRA (where the taxes were paid from the Traditional IRA) is worth $59,011 and her savings of $6,600 is worth $18,982 after paying capital gains taxes at 15%. Her two accounts are worth $77,993 after taxes using a 6% rate of return.
- In scenario 2, where the taxes were paid from a taxable account, the Roth IRA is worth $80,178 and her savings is worth $1,725 after paying capital gains at 15%. Her two accounts are worth $81,903 after taxes using a 6% rate of return.
- In scenario 3, Hope's $25,000 Traditional IRA is worth $54,521 after she paid taxes at 32% because her tax bracket was higher in retirement, and her savings of $6,600 is worth $18,982 after paying capital gains taxes at 15%. Her two accounts are worth $73,503 after taxes using a 6% rate of return.
- In scenario 4, shows Hope's $25,000 Traditional IRA is worth $60,936 after she paid taxes at 24% because her tax bracket ended up being the same in retirement, and her savings of $6,600 is worth $18,982 after paying capital gains taxes at 15%. Her two accounts are worth $79,918 after taxes using a 6% rate of return.

As you can see from these hypothetical examples your tax rate, rate of return on your investments, and funds used to pay your taxes have a lot to do with how beneficial a Roth conversion may be to you.

Hope's hypothetical examples





The information in the charts above is hypothetical and provided for informational purposes only. It is not intended to represent any specific investment nor is it indicative of future results.

Talk with Wells Fargo Advisors

If you are thinking about a Roth conversion, we suggest you speak with your tax advisor as well as your financial advisor with Wells Fargo Advisors. They will be able to review your specific situation and discuss a Roth conversion in more detail.

With you every step of the way

Your Wells Fargo Advisors financial advisor can support you in your retirement planning process by providing the guidance needed to make informed choices. You'll work together to design and implement an investment plan that can help you live out your unique vision of retirement.

Traditional IRA distributions are taxed as ordinary income. Qualified Roth IRA distributions are not subject to state and local taxation in most states. Qualified Roth IRA distributions are also federally tax-free provided a Roth account has been open for more than five years and the owner has reached age 59½ or meets other requirements. Both may be subject to a 10% additional tax if distributions are taken prior to age 59½.