

What do I Need to Know, Now That I Have Converted to a Roth IRA From a Traditional IRA?

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By converting to a Roth IRA, you have taken a step that will potentially provide you with tax-free income for your retirement and/or a tax-free inheritance for your heirs. However, there are significant differences in how Roth IRAs are treated versus Traditional IRAs. The following questions and answers are designed to help you understand your new opportunities and limitations.

- Q. I know that I may owe federal income tax on the funds I converted, but will I have to pay state taxes as well? What about distributions?**
- A.** Some states tax the converted amount and some states do not. Also, the state income tax treatment of Roth IRA distributions may differ from the federal tax treatment. This document addresses certain aspects of the federal tax treatment of Roth IRAs and does not attempt to address the state income tax treatment of Roth IRAs. Consult your tax advisor to determine whether your state (a) imposes taxes on Roth IRA conversions and/or (b) taxes Roth IRA distributions differently than the federal tax rules.

Q. Can I pay the taxes due now on my conversion from funds in my IRA?

A. It's generally better to identify funds outside the IRA to pay the taxes, since tapping into the IRA may offset any gains generated by the conversion. If you use funds outside the IRA, you'll have more assets benefiting from the tax-deferred growth potential of your Roth IRA. In addition, if you are under age 59½ and withdraw money from your IRA to pay the taxes, a 10% penalty tax will be further imposed on the taxable portion of that distribution, unless an exception applies.

Q. Is it possible to recharacterize (i.e., undo) a Roth Conversion?

A. Effective January 1, 2018, a Roth IRA conversion cannot be recharacterized.

Q. I pay estimated taxes. What should I do?

A. You need to consider the taxable portion of the converted amount in projecting your estimated taxes because the taxable amount converted to a Roth IRA is considered additional income. Be sure to consult with your tax advisor about estimated tax payments and whether you may be subject to the alternative minimum tax (AMT), which is, in effect, an alternative set of rules for calculating your income tax with its own definition of taxable income, exemptions and tax rates.

Q. My Traditional IRA consists of both nondeductible and deductible contributions. How does this affect the taxes I owe on my Roth conversion?

A. If your Traditional IRA has been funded with any nondeductible (or after-tax) amounts, then your Roth conversion is generally subject to what's known as the "pro rata rule." Basically, the amount converted will consist of both nondeductible (or after-tax) amounts and pretax amounts (e.g., deductible contributions and

tax-deferred earnings), in proportion to the funds in your existing accounts.

Here's an example: Let's say you have a total of \$200,000 in all your IRAs, made up of \$50,000 (25%) in nondeductible or after-tax amounts and \$150,000 (75%) in pretax amounts. If you convert \$50,000 to a Roth IRA, then \$12,500 (25%) would be converted tax free and \$37,500 (75%) would be taxed as ordinary income.

Please note:

- When determining the taxable portion of a conversion, you need to look at your entire IRA picture, including Traditional and Rollover IRAs, as well as SEP, SAR-SEP and SIMPLE IRAs (but not Roth IRAs).
- Although the conversion distribution (or deemed distribution) is based on the Fair Market Value (FMV) of the assets on the date of the conversion distribution (or deemed distribution), the pro rata rule uses the total value of all your IRAs as of December 31 in the year you convert; you may not calculate based on the value on the date of conversion. If the account value changes by the end of the year (due to earnings or losses in your accounts), then your taxes may be higher or lower than anticipated.
- If you roll over assets from a former employer's retirement plan to a Traditional IRA in the same year as your Roth conversion, the rollover assets will be included as part of the total value in your IRAs. This can affect your pro rata calculation.
- Be sure that you filed IRS Form 8606 for each year that you made a nondeductible contribution.
- Your tax advisor can help you calculate the taxable portion of the conversion distribution.

Q. I have a 401(k) at a former employer. Can I convert these funds as well?

A. Conversions to a Roth IRA are not limited to funds from a Traditional IRA. Assets in an employer-sponsored plan

can be converted to a Roth IRA if they are eligible for distribution and eligible for rollover. For example, if you have vested assets in a former employer's plan or you are eligible to take an in-service withdrawal from your current employer's plan, then conversion of those assets is permitted. Your former employer's plan may also permit "Roth 401(k)" conversions within the plan, which you should discuss with your former employer's plan administrator as to any restrictions or limitations.

Q. I own company stock in my employer-sponsored retirement plan. Can I convert my shares to a Roth IRA?

A. It may be advantageous to convert your stock to your Roth IRA, but there's also a strategy, called net unrealized appreciation (NUA), that you may wish to consider instead of converting your employer securities. With NUA, employer stock can receive special tax treatment under certain circumstances. This can be a particularly significant benefit if you are highly compensated or if your employer stock has appreciated significantly. The NUA rules are complicated (especially as they relate to Roth IRA conversions), so please consult your tax advisor as to which strategy is most beneficial in your circumstances.

Q. I converted my Traditional IRA to a Roth IRA, but my income is too high to make future Roth contributions. What can I do?

A. You may be able to convert some of your retirement savings into a Roth IRA in the future. NOTE: Even if you are not eligible to make annual Roth IRA contributions, you can generally make nondeductible annual contributions to a Traditional IRA if you have sufficient taxable compensation. Make sure you file IRS Form 8606 with your return each year to substantiate the tax basis of the contribution. If the amount converted consists of after-tax amounts

(e.g., nondeductible contributions), you won't owe taxes on the after-tax portion of your converted assets; only the pre-tax portion (i.e., deductible contributions and earnings) of your converted assets will be subject to income taxation.

Q. Do Roth IRAs require minimum distributions during my lifetime?

A. With a Roth IRA, you are not required to take distributions. However, after your death, your beneficiaries will generally be subject to the required minimum distribution rules, but your spouse can generally avoid having to take required minimum distributions by either (a) treating the Roth IRA as his or her own, or (b) rolling the Roth IRA assets over into his or her own Roth IRA. This provides you with greater control over your income in retirement—so you can tailor withdrawal amounts to your actual income needs or eliminate them altogether in any given year.

Q. If I don't need all my Roth IRA funds during my retirement and leave those assets to my children and grandchildren as a financial legacy, will their inheritance be income tax free?

A. Since there is no age restriction on contributions and no required minimum distributions during your lifetime, you can leave as much of your money in the account as you wish. This means you could have more to pass on to your heirs and your heirs should be able to withdraw these assets without incurring income taxes, subject to certain conditions.

Please note:

- If you designate a beneficiary who is considered two or more generations younger than you (e.g., grandchild), the transfer of an interest in the IRA to such a beneficiary at your death may be subject to the generation skipping transfer tax, in addition to estate tax. Before naming such an individual as

your beneficiary, you should consult with and rely on your own independent legal and tax advisors.

Q. When I make withdrawals from my Roth IRA, are the funds distributed in any particular order?

A. The IRS rules determining the order in which assets will be distributed from a Roth account are as follows:

- 1. Contributions** come out first.
- 2. Taxable** conversions and retirement plan rollover assets are next.
- 3. Nontaxable** conversions and retirement plan rollover assets come out after that.
- 4. Earnings** are the last category to be distributed.

Please note:

- Taxable conversion and retirement plan rollover assets are pretax assets that are taxed in the year of conversion or rollover.
- Nontaxable conversion and retirement plan rollover assets are nondeductible (or after-tax) Traditional IRA assets or retirement plan assets (excluding designated Roth contributions) that are not taxable at the time of conversion or rollover.
- If you have made more than one conversion or retirement plan rollover, conversion and rollover assets are distributed on a first-in, first-out basis by year.

Q. If I need to access my Roth conversion funds before I retire, will I have to pay taxes or penalties?

A. Whether a distribution will be taxable and/or incur a penalty tax depends on your age, how long you have held the converted funds in your Roth IRA, which assets are distributed and how the funds will be used. Withdrawals of after-tax contributions (e.g., nondeductible contributions) are generally always income tax free because these amounts have already been taxed (but, as noted below, certain converted amounts may be subject to an additional 10%

penalty tax if withdrawn too soon after conversion, unless an exception applies). Withdrawals of earnings from a Roth IRA are typically income tax free, as long as certain requirements are met (discussed below).

The first condition for a distribution of Roth IRA earnings to be income tax free is that the withdrawal is made after the 5-tax-year period, which begins with the first tax year for which you made a contribution (or in which you made a rollover or conversion contribution) to any Roth IRA established for you as owner (not as beneficiary of a deceased individual). Additionally, you must be at least 59½ years old at the time of withdrawal—or you must use the money to fund a qualified first-time home purchase (maximum \$10,000) or the withdrawal must be made on account of your qualifying disability or death. If both conditions are not satisfied, the earnings you withdraw will be subject to ordinary income taxes and may be subject to a 10% penalty tax, unless an exception applies.

Please note:

- If you withdraw converted assets (or taxable retirement plan rollover assets) within the 5-tax-year period, starting with the first day of the tax year in which you made that particular conversion (or rollover) contribution, the withdrawn taxable conversion (or retirement plan rollover) assets will not be subject to ordinary income taxes, but may be subject to a 10% penalty tax, unless an exception applies.
- If the taxes on the conversion have not been fully paid at the time you take a distribution, they will be due the year in which you take the distribution.

Your Roth IRA: A Key Component of Your Retirement Income Plan

As you work to build your retirement nest egg, it's important to remember that these retirement savings—including investments, 401(k)s, pensions and IRAs—will one day become the source of

your retirement income. Your new Roth IRA is an important component of your retirement income strategy, since your Roth assets may one day provide tax-free retirement income.

Your Financial Advisor or Private Wealth Advisor can work with you to help develop an integrated retirement income strategy, one that aligns your financial resources with your retirement needs. This approach will include strategies for generating and maintaining the income you'll require while preserving the wealth you've accumulated. Be sure to let your Financial Advisor or Private

Wealth Advisor know about all of your retirement assets, because having a holistic view of your retirement portfolio is critical to creating a successful strategy. Think about it as planning for your retirement paycheck.

¹Typically, as a retirement plan participant who is changing employers, or ending his/her employment with the plan sponsor, you have the following four options (and you may be able to engage in a combination of these options depending on your employment status, age and the availability of the particular option):

1. Cash out the account value and take a lump sum distribution from the current plan subject to mandatory 20% withholding, as well as potential taxes and a 10% penalty tax, OR continue tax-deferred growth potential by doing one of the following:
2. Leave the assets in your former employer's plan (if permitted),
3. Roll over the retirement savings into your new employer's qualified plan, if one is available and rollovers are permitted, or
4. Roll over the retirement savings into an IRA.

Some of the factors you should consider when making a rollover decision include (among other things) the differences in: (1) investment options, (2) fees and expenses, (3) services, (4) penalty tax-free withdrawals, (5) creditor protection in bankruptcy and from legal judgments, (6) Required Minimum Distributions, or "RMDs," (7) the tax treatment of employer stock, and (8) the availability of plan loans (e.g., loans are not permitted from IRAs, and the availability from an employer's qualified retirement plan will depend on the terms of the plan). For more details about your options and the factors you should consider, please review our Rollover Guide.

A Roth Conversion may not be right for everyone. There are a number of factors taxpayers should consider before converting, including (but not limited to) whether or not the cost of paying taxes today outweighs the benefit of income tax-free Qualified Distributions in the future. Before converting, taxpayers should consult their tax and legal advisors based on their specific facts and circumstances.

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