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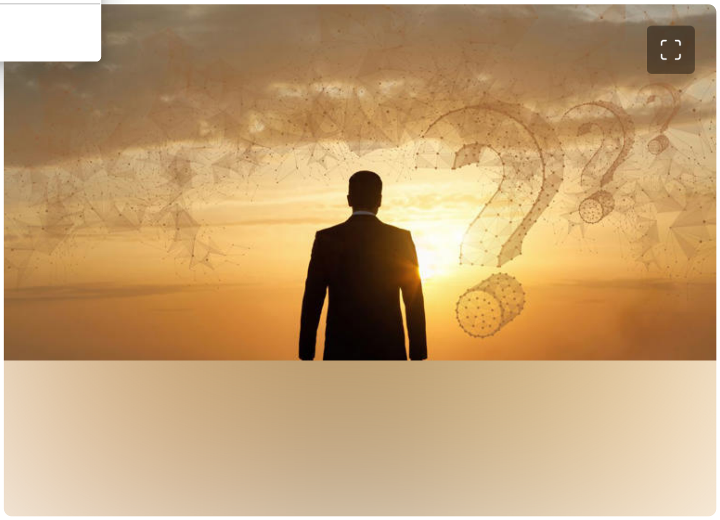
I'm in my 70s and doing Roth conversions, but I'm not sure I'm doing it right

Story by Beth Pinsker • 1mo



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FIX MY PORTFOLIO

Got a question about the mechanics of investing, how it fits into your overall financial plan and what strategies can help you make the most out of your money? You can write me at beth.pinsker@marketwatch.com.

Dear Fix My Portfolio,

I read your recent article on the 68-year-old who wants to convert his whole 401(k) to a Roth account. I'm guessing my situation is the same, but slightly different.

I'm in my early 70s and I am in the process of converting my rollover IRA to a Roth IRA account gradually over a period of years. I started the conversions in 2014 into a Roth account which I have had open for 20-plus years. If I continue with the conversions on my schedule, I will complete all the conversions by 2025.

I just want to make sure: Does the five-year rule for conversions apply to conversions from rollover IRA accounts to Roth accounts the same as the 401(k) conversions do? And if so, am I correct in assuming that the balance in the Roth account prior to 2018 is safe to withdraw at this time, tax-free and penalty-free, since those contributions, conversions and earnings are now older than five years? It is not my intention to withdraw these funds, but life is unpredictable, and emergencies do come up sometimes.

Slightly Unsure

Dear Slightly Unsure,

You're not the only one who is questioning how it's best to handle Roth conversions—a lot of people question this and even the pros constantly debate the rules! For one thing, the government keeps changing the parameters. One big switch: You used to be able to change your mind about Roth conversions in a calendar year, and now you can't anymore.

Another big confusion is that there are two different five-year rules. The first says your Roth account must be open for five years or else you will be taxed on any growth you withdraw. The second is that each year's Roth conversion has its own five-year clock, mostly to avoid a 10% early withdrawal penalty, that could impact you if you're younger than 59½ or haven't met the first five-year rule.

The IRS provides only limited guidance on how you're supposed to functionally manage the ins and outs of Roth IRAs and conversions. The record-keeping is up to you (or your adviser) and so you have to figure out what works best for you, and that means everyone does things a little differently.

But first, the easy answer: Yes, the same rules apply for Roth conversions from 401(k)s and IRAs, or 403(b)s or any other plan that's referred to as a "qualified" plan where the money hasn't been taxed yet. Before you can transfer that pretax money to a Roth, where it will grow tax-free, you have to pay the government its share.

What can you withdraw, and when

The tricky stuff comes into play when you want to take money out of your Roth account and you've commingled funds from various sources at various times, and all of it will have presumably grown over time. So what money are you actually taking out? There's no real way to map it within one account.

The IRS does have some guidelines over how withdrawals are considered for Roth IRAs—first out are your regular contributions, then conversions, then earnings. "Each layer must be fully withdrawn prior to a subsequent layer being accessed," says Sean Mullaney, a financial planner and certified public accountant based in Woodland Hills, Calif.

Say you converted $10,000 and then directly put in $7,000, and the account grew over time to $25,000 total. When you start to withdraw money, the first $7,000 you take out is considered your direct contributions, regardless of the order it went into the account. Since contributions and conversions can always be withdrawn at full value—you pay the tax before it even goes into the account—you only have to consider the impact of penalties and taxes on the growth portion of the account, which comes out last.

Some financial advisers, like Kashif Ahmed at American Private Wealth in Bedford, Mass., suggest creating a separate bucket for each year's Roth conversions (they get lumped together by calendar year, regardless of how many transfers you make in a year) and keep things separate. This made particular sense when you could get a do-over on Roth conversions if the market went down.

Other readers have asked what to do if you've already started doing conversions into one jumbo account, and then you realize it's hard to keep track of it all. You don't have to worry about unwinding it for any IRS purposes.

"In terms of taxation and distributions, you don't need to worry about separate accounts," says Mullaney. Still, you can end up going down a rabbit hole of possible complications that might make you consider it, like creditor protection, and so forth. "It's a little bit like a choose-your-own-adventure as to how complicated it gets," he adds.

What you need to do is figure out a way to keep track of the money going in and out of the account. Eric Bronnenkant, head of tax at Betterment, keeps track of his Roth accounting on a spreadsheet, and tracks conversions with IRS form 8606. "I don't think it's difficult to keep track of it," he says, "But not everyone is an accountant."

The big thing to remember is that once you are over 59½, the five-year-rule on conversions has little impact on you, because it's mostly there to prevent younger people from circumventing the 10% penalty on early withdrawals. "The five-year 10% penalty rule is never an issue once an individual reaches age 59½," says retirement expert Ed Slott in a recent subscriber newsletter for his website IRAHelp.com.

But that said, a person who is 70 and doing a Roth conversion might still be subject to the first five-year Roth rule—which Slott calls the "five-year forever rule"—that says your have to have a Roth account that has been open for at least five years in order to take out your growth tax-free.

So if you are 70 and you do a Roth conversion into a brand-new Roth IRA account, you will pay ordinary income tax on any growth you withdraw from the account before that five years is up. The circumstance that would have you pay the most is if you are younger than 59½, you do a conversion, and then withdraw all the money before you meet the five-year rule—you'd pay a 10% early withdrawal fee and tax on any growth.

In your case, since you're 70-ish and your Roth IRA account has been open for more than five years, it doesn't look like you'll have to pay taxes or any penalties on your withdrawals. If you want to be sure, you should consult with a tax professional who can look at your accounts and your tax forms.

But that doesn't get you off the hook for your own record-keeping. The rules could change at any time, and so you still need to keep track of what you put into your account, and when, in case the IRS comes looking for payment.

More Fix My Portfolio

- I'm 68 and want to eventually convert my whole 401(k) to Roth. Will I have to wait five years to touch it?
- I'm 65 with more than $5 million saved and I can't figure out how to spend it fast enough to avoid an RMD disaster
- I earn $75,000 and was counting on my kids receiving need-based college aid, but now I'm inheriting $250K and don't know how to hide it

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- Very closely
- Somewhat closely
- Not closely at all
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