Case of the Week: The Affect of Withholding on Roth IRA Conversions

Our ERISA consultants on the Columbia Management Learning Center Resource Desk regularly receive calls from financial advisors who have questions on conversions from Traditional IRAs to Roth IRAs.

Through our relationship with the Columbia Management Learning Center, we guide Columbia Management's financial advisor partners through the IRS and/or Department of Labor (DOL) rules and regulations that provide guidance on conversions from Traditional to Roth IRAs.

A recent call with an Ameriprise advisor in Colorado is representative of a common question regarding federal tax withholding on converted amounts and the application of the early withdrawal penalty. The advisor asked: **"If my client converts an amount from a traditional IRA to a Roth IRA, and chooses to have 10 percent of the amount withheld for federal income tax purposes, what would be the tax and penalty ramifications?"**

Highlights of Recommendations

- An IRA owner must include any pre-tax amounts that are converted in taxable income (Treas. Reg. 1.408A-4, Q&A-7(a)).
- The 10 percent early withdrawal penalty does not apply to converted amounts (Treas. Reg. 1.408A-4, Q&A-7(b)).
- If an investor elects to have withholding apply to a conversion, the IRA administrator must remit the withheld amount to the IRS, leaving the balance as the amount that is actually converted to the Roth IRA. The converted amount is included in taxable income to the extent it is pre-tax, but not subject to the early withdrawal penalty; the withheld amount is includable in taxable income and would be subject to the early withdrawal penalty as well, unless the IRA owner has a penalty exception (e.g., age 59 ½).
- In order to execute a conversion, an IRA owner must complete a conversion request form, like the one available through Ameriprise. The conversion request form can be a great source of information that can be useful in explaining the taxation, withholding and penalty rules that apply to conversions.
- IRA administrators must generate IRS Forms 1099-R and 5498 to properly report a conversion and any amounts withheld for federal tax purposes.
- It is important to include a client's tax advisor in any discussions that deal with the tax implications of a conversion.

<u>Conclusion</u>

When completing a Roth IRA conversion, the financial organization's conversion request form can be used to help a client understand the tax ramifications. With the expert guidance of the Columbia Management Learning Center, advisors can confidently assist their clients with the conversion process.