

In the Spotlight

A GUIDE TO ROTH CONVERSIONS



Q1: Are there restrictions on an IRA owner's eligibility to do a Roth conversion?

A: There are no longer any restrictions on an IRA owner's eligibility to execute a Roth conversion. For any tax year prior to 2010, taxpayers (whether filing individually or jointly) whose Modified Adjusted Gross Income (MAGI) was greater than \$100,000 were not eligible to do a Roth conversion. Taxpayers who were married and filing separately were also ineligible for Roth conversions, regardless of MAGI. With the passage of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), beginning in tax year 2010, the \$100,000 MAGI restriction and filing status restriction have been lifted, allowing anyone, regardless of income or filing status, to do a Roth conversion.

Q2: Why would someone want to do a Roth conversion?

A: A Roth IRA offers several advantages:

- The ability to receive tax-free distributions
- No Required Minimum Distributions (RMD) while the account owner is alive
- The ability to pass the asset to a beneficiary income tax-free

Q3: Why would someone not want to do a Roth conversion?

- Inability to pay the tax on conversion income
- The taxpayer expects future tax rates to be lower
- A need for income limits the taxpayer's ability to take advantage of tax-free compounding

Q4: What types of accounts/plans can be converted to a Roth IRA?

A: Traditional, SEP, and SIMPLE IRAs can be converted to a Roth IRA. In addition, the Pension Protection Act of 2006 authorized the direct conversion of eligible distributions from other eligible retirement plans to a Roth IRA. Other eligible

retirement plans include IRC Section 401(a) plans (such as 401(k), Profit-Sharing, Money Purchase, and Defined Benefit plans), 403(b) and eligible 457 governmental plans. Prior to January 1, 2010, taxpayers converting from eligible retirement plans were subject to the same \$100,000 MAGI and filing status restrictions that governed IRA conversions. Eligible distributions can include lump-sum distributions at separation from service as well as in-service distributions.

Q5: Can assets in an employer-sponsored qualified retirement plan be converted to Roth status while held in the plan?

A: The Small Business Jobs Act of 2010 contained provisions allowing for the ability to convert traditional plan assets to Roth status within a 401(k), 403(b), or government-sponsored 457(b) plan that provides for a Designated Roth component, effective September 27, 2010. This was followed on November 26, 2010 by formal guidance on procedures from the IRS in Notice 2010-84. In order for an internal Roth rollover to take place:

1. The plan must include a Designated Roth component which allows for contributions and accepts rollovers. If the plan does not include a Roth component, the plan may be amended to include one.
2. The funds distributed and rolled over to the Roth component will be subject to income tax to the extent the funds do not represent after-tax contributions to the plan.
3. The funds rolled over to the Roth component are not subject to the standard 20% withholding on plan distributions, nor are they subject to the 10% early withdrawal penalty tax.

An additional requirement, that the in-plan Roth rollover may only be made with funds that are eligible for distribution from the plan and would otherwise be considered an eligible rollover distribution, was eliminated by the American Taxpayer Relief Act of 2012, which authorized the conversion to Roth status of funds which are not eligible for distribution from the plan. Funds converted to Roth status through an "in-plan" Roth conversion are not eligible for recharacterization. See Q22.


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Q6: Can an individual taking RMDs do a Roth conversion?

A: Yes, however, the IRA owner's current year RMD is not eligible for conversion and must be withdrawn first. Balances remaining after distribution of the RMD amount can be converted. An individual does not need to have earned income to do a Roth conversion.

Q7: Can a beneficiary of an inherited IRA or inherited employer plan do a Roth conversion?

A: The ability to convert inherited money depends on whether the money is in an IRA or an employer-sponsored retirement plan and/or if the beneficiary is a spouse or a non-spouse.

- A non-spouse beneficiary of an IRA cannot convert an inherited account to a Roth IRA under any circumstances.
- A spousal beneficiary of an IRA or employer-sponsored retirement plan may convert the account to Roth status after personally assuming the account.
- A non-spouse beneficiary of an employer plan can rollover and convert plan assets to a beneficiary Roth IRA.

Q8: What are the tax consequences of a Roth conversion?

A: Roth conversions generally require income tax to be paid on the entire amount converted. That amount will be subject to federal income taxes, and potentially state income taxes, at the individual's ordinary income tax rate.

Q9: Is a Roth conversion subject to the 10% additional tax on early withdrawals?

A: No. The 10% additional tax that would normally apply to a premature distribution from an IRA does not apply to Roth conversions.

Q10: Can an individual pay the taxes due on the conversion from the amount converted?

A: Yes. However, while the taxpayer may elect state and federal withholding during the conversion process, or make withdrawals at a later date to pay the tax, it's generally best to pay the tax from another source. Taking cash from the converted amount would lessen the benefit of the conversion. In addition, if the taxpayer is under age 59½, the 10% additional tax on early withdrawals would apply on the amount taken in cash to pay the income tax liability.

* Please note that many IRA custodians, including Prudential, do not track pre-tax and after-tax balances in IRAs. An IRS Form 1099-R issued in conjunction with a Roth conversion would show the entire conversion amount as pre-tax. Taxpayers should work with their tax advisors and use the information previously filed using IRS Form 8606 to determine what portion of their conversion is pre-tax money and what portion is after-tax money, if any.

Q11: What if the amount converted contains after-tax money?*

A: After-tax money will not be subject to taxation again upon conversion.

Q12: Must an individual convert an entire IRA to a Roth IRA, or can a partial conversion be done?*

A: An individual can choose to convert any or all of an IRA to a Roth IRA. If an account contains both pre-tax and after-tax money, and a partial conversion is done, the amount converted will be taxed on a pro-rata basis.

For example, assume an individual has a traditional IRA with a total balance of \$100,000, \$20,000 of which is after-tax. If he converts \$25,000, the taxable amount would be determined as follows:

First, determine proportion of account subject to tax:

$$\$80,000 / \$100,000 = 80\% \rightarrow \text{taxable portion of account}$$

$$\$20,000 / \$100,000 = 20\% \rightarrow \text{non-taxable portion of account}$$

Second, apply the percentages to the conversion amount:

$$\text{Taxable amount of conversion} = \$25,000 \times 80\% = \$20,000$$

$$\text{Non-taxable amount of conversion} = \$25,000 \times 20\% = \$5,000$$

Q13: If an individual has more than one traditional IRA, but only converts one account, how is the taxable amount determined?

A: All IRA balances, including SEP IRA and SIMPLE IRA balances, must be aggregated to determine the taxable amount of the conversion.

Using the example in Q12, assume the taxpayer had a second IRA with a balance of \$50,000, all of which is pre-tax. The taxable amount of the \$25,000 conversion would be determined as follows:

First, determine taxable portion of aggregated IRA balances:

$$\$100,000 + \$50,000 = \$150,000 \text{ Total of all IRA balances}$$

$$\$130,000 / \$150,000 = 87\% \text{ Taxable portion}$$

$$\$20,000 / \$150,000 = 13\% \text{ Non-taxable portion}$$

Second, apply to conversion amount:

$\$25,000 \times 87\% = \$21,750$ taxable portion of conversion

$\$25,000 \times 13\% = \$3,250$ non-taxable portion of conversion

Q14: Is the ratio of taxable to non-taxable dollars determined at the time of conversion?

A: No. The final determination of the ratio of taxable to non-taxable dollars in a conversion is made based on account values as of December 31 of the year in which the conversion takes place.

Q15: If an individual is converting money from an employer-sponsored retirement plan, can after-tax money in the plan be converted to a Roth IRA?

A: Yes. After-tax money in an employer-sponsored retirement plan is eligible for conversion to a Roth IRA.

On September 18, 2014 the IRS issued Notice 2014-54 "Guidance on Allocation of After-Tax Amounts to Rollovers".

This Notice provided guidelines and procedures for taxpayers and qualified plan administrators to allow participants to control the allocation of plan balances. As a result, it is possible for plan participants to segregate after-tax money in the rollover and to allocate those funds to Roth IRAs.

Plan participants must verify their plan administrator's procedures for implementation of the IRS guidelines, and must inform the plan administrator of their allocation elections BEFORE any rollover takes place.

If properly executed, this process will allow all pre-tax money to be rolled over without taxation to a traditional IRA, and after-tax funds to be converted to Roth IRA status. The conversion of after-tax dollars to Roth status will not create a tax liability for the plan participant.

Please note that in recent years, legislation has been proposed (which has not passed but may be revived), which would prohibit the conversion of after-tax money in IRAs and qualified retirement plans to Roth status.

Q16: Is an individual who converts money from an employer-sponsored retirement plan required to aggregate all retirement plans for determining taxation the way he must with IRAs?

A: No. Employer-sponsored retirement plans are not subject to the same aggregation rules to which IRAs are subject. However, SEP IRAs and SIMPLE IRAs are included in the definition of IRA and would need to be aggregated with other traditional IRAs.

Q17: How is the amount of the conversion subject to tax determined when the IRA is invested in an annuity?

A: The amount used as the basis for Roth conversion taxation is the market value of the contract PLUS the Actuarial Present Value (APV) of ALL benefits associated with the contract. If the conversion is accomplished by a complete surrender of the annuity contract for cash, which terminates all benefits and other features of the contract, or by a partial surrender for cash, then only the cash surrender value is used as the basis for the Roth conversion.

Q18: How is the APV determined?

A: The calculation of the APV is complicated and encompasses a wide range of factors. The Treasury Regulations require only that the calculation be done "using reasonable actuarial assumptions." Thus, each annuity provider is allowed to develop its own proprietary formula for calculating APV.

Q19: Does conversion of a traditional IRA funded with an annuity to a Roth IRA affect the guarantees provided to the contract owner?

A: Riders and the guarantees which they offer may be affected by the conversion to Roth status. Whether or not this occurs will depend on the type of conversion executed, the terms of the annuity contract and the issuing company's procedures.

A full Roth conversion of a Prudential annuity will typically result in no changes. If the client converts the entire contract to Roth status, the riders on the contract, and all guarantees associated with them typically are maintained without change, nor is any alteration made to the client's CDSC schedule.

A partial Roth conversion of a Prudential annuity will require that some portion of the original traditional IRA account be withdrawn from the existing contract and moved to a new Roth IRA contract. This withdrawal can affect the accumulation and amount of benefits associated with the traditional IRA contract, and may be subject to CDSC. The new Roth IRA annuity contract will have its own CDSC schedule, and new riders will need to be elected for the new contract. If electing a full conversion, withholding of taxes from the converted amount will count as a withdrawal, potentially subjecting the contract to CDSC and rider adjustments.

Q20: When are distributions from a Roth IRA income tax-free and tax penalty-free?

A: A distribution from a Roth IRA that is tax-free and penalty-free is known as a qualified distribution. A distribution is qualified when it passes the following two-prong test:

1. The taxpayer has held any Roth IRA for at least five tax years; AND
2. The distribution is made for one of the following reasons:
 - a. Attainment of age 59½
 - b. Death of the owner
 - c. Disability of the owner
 - d. Purchase of a first home (\$10,000 lifetime maximum)

The five-year clock begins on the earlier of January 1 of the year for which the first contribution to the account was made, or January 1 of the year in which the first conversion was made.

When the distribution from the Roth IRA does not satisfy these conditions, it is treated as a “non-qualified distribution.” The Internal Revenue Code specifies the order in which non-qualified distributions from a Roth IRA are deemed to be withdrawn. Distributions are made as follows:

1. Roth Contributions
2. Roth Conversion and Rollover Contributions (first in, first out)
 - a. From the taxable portion of the conversion/rollover
 - b. From the non-taxable portion
3. Earnings

It is important to note that Roth IRA contributions are made with after-tax dollars and are tax-free and penalty free when withdrawn. Therefore, if only out-of-pocket contributions are withdrawn, there would be no taxation, and no additional tax on early withdrawals.

Q21: Can funds that are converted to a Roth IRA be withdrawn immediately on a tax-free basis?

A: No. Amounts distributed from converted dollars in a Roth IRA are not considered to be fully tax-free (or “qualified”) unless they are made by a taxpayer who has held a Roth IRA for more than five tax years and the distribution is made upon attainment of age 59½, death, disability or first time home purchase (\$10,000 lifetime maximum).

If a distribution is made from converted dollars prior to the satisfaction of the noted conditions, there will be no additional income tax payable on the conversion dollars distributed (since the income tax was paid at the time of conversion). However, conversion amounts that are not considered “qualified” would be subject to the 10% additional tax on early withdrawals (unless an exception, such as age 59½, applies).

If multiple conversions are done, each conversion has its own five-year clock. Each five-year period begins on January 1st of the year the conversion is made, regardless of the actual conversion date.

If the Roth IRA funded by the conversion is not the taxpayer’s only Roth account, or is a pre-existing Roth account, the taxpayer must still track a 5-year calendar for the conversion dollars; this is independent of the 5-year calendar that measures the start of the taxpayer’s Roth status. The calendar that measures Roth qualification status begins on the earlier of January 1 of the year for which the first contribution to the account was made, or January 1 of the year in which the first conversion was made. Because of this, even though the taxpayer’s Roth participation may have begun more than five years prior to any withdrawal, conversion dollars may still be subject to the 10% additional tax if the five-year conversion calendar has not elapsed.

Q22: What is a recharacterization?

A: A recharacterization is the ability to elect to change the treatment of a traditional IRA or Roth IRA contribution. The contribution amount, adjusted for gains or losses, is moved back to a traditional IRA (in the case of the recharacterization of a Roth contribution).

A recharacterization must generally be done by the due date of the taxpayer’s tax return (for many taxpayers, this would be April 15). However, if the taxpayer timely filed their tax return without having transferred the funds back to a traditional IRA, they can do the recharacterization within six months of the due date of the return, excluding extensions.

Pub. L. 115-97, also known as the Tax Cuts and Jobs Act, rescinded the ability to recharacterize Roth conversions executed after December 31, 2017. However, the law did not rescind the ability to recharacterize traditional IRA and Roth IRA contributions.

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Tax deferral is provided by an IRA and other qualified retirement plans. When a variable annuity contract is used to fund a qualified retirement plan, it is important to consider its features other than tax deferral, including: any lifetime income payout option; the death benefit protection; and the ability to transfer among investment options without sales or withdrawal charges.

Conversions to a Roth IRA are generally fully taxable. Before clients convert to a Roth IRA, consider how their tax bracket will affect the overall benefit of the rollover. Conversion income may push them into a higher tax bracket. It is, however, possible to convert only part of their traditional IRA. This could enable them to remain in the same tax bracket they would be in without the conversion.

It is generally advisable to pay the taxes on the conversion with funds other than those in a client's traditional IRA. If clients are under age 59½ when they do a conversion, any funds not deposited in the Roth IRA will be subject to a 10% additional tax (unless an exception applies).

A variable annuity is a long-term investment designed for retirement purposes. Investment returns and the principal value of an investment will fluctuate so that an investor's units, when redeemed, may be worth more or less than the original investment. Withdrawals or surrenders may be subject to contingent deferred sales charges. Withdrawals and distributions of taxable amounts are subject to ordinary income tax and, if made prior to age 59½, may be subject to a 10% additional tax. Withdrawals reduce the account value and the living and death benefits.

Optional living and death benefits may not be available in every state and may not be elected in conjunction with certain optional benefits. Optional benefits have certain investment, holding period, liquidity, and withdrawal limitations and restrictions. The benefit fees are in addition to fees and charges associated with the basic annuity. Please see the prospectus for more information.

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