Tax-Free Roth Conversion With a "Mixed" IRA

Take-Away: There is one way in which to *separate the cream from the coffee* if an individual's goal is to roll over funds from a traditional IRA to a Roth IRA and not incur any income tax on the rollover.

Background: We've covered this topic in the past (some would say *ad nauseum)* the so-called pro rata rule, when an IRA holds both pre-tax and after-tax contributions and the impact that pro rata rule has on Roth IRA conversions, i.e., the *cream-in-the-coffee* problem. However, it never hurts to have a refresher of the *cream-in-the-coffee* rule.

There exists a statutory work-around to the pro rata rule and thus a way to make a tax-free Roth conversion with a 'mixed-contribution' traditional IRA. Normally, while a Roth IRA conversion can be made with IRAs that have mixed contributions, when this is done, the IRA owner will owe income taxes on the portion of the Roth IRA rollover that includes pre-tax money. Even when the pre-tax money is held in a separate traditional IRA, the conversion of the post-tax money will be partly taxed due to the *cream-in-the-coffee* rule, which requires that all IRAs be consolidated as a single IRA regarding distributions, including Roth IRA conversions.

Example: Andy owns several IRAs that are collectively comprised of $5,000 in deductible contributions, $4,000 in non-deductible contributions, and $1,000 of growth in the contributed IRA assets. Andy's IRA are treated as a single IRA for distribution and thus rollover purposes. If Andy converts $1,000 to a Roth IRA, he will be taxed on 60% of the $1,000 Roth IRA conversion; 40% of the conversion will be non-taxable to Andy. That's because there is a total of $4,000 (40%) in Andy's traditional IRA that represents his non-deductible contributions, which can be converted tax-free to the Roth IRA. Andy's deductible IRA contributions and the growth in Andy's traditional IRA are taxable distributions to him. Accordingly, converting the pre-tax contributions and growth to a Roth IRA will result in including $600 in Andy's income for the year of the Roth conversion as a taxable to Andy.

Roll-In Pre-Tax Funds: If a traditional IRA owner also participates in a 401(k) plan at work (or another qualified retirement plan) there is an option to roll over the pre-tax funds from the traditional IRA to the qualified retirement account, like a 401(k) plan. Many qualified retirement accounts have the option to allow for a *roll-in* of IRA funds, but only if the funds consist of pre-tax dollars, as in tax-deductible contributions and earnings on the IRA's assets. In short, *the cream can be physically separated from the coffee,* by *rolling in* the pre-tax dollars to the qualified plan account. What is then left in the traditional IRA are after-tax contributions which then can be freely converted by the IRA owner to a Roth IRA without incurring any income tax on the conversion.

Example: The same facts in the Andy example from above. Andy decides to *roll-into* his employer's 401(k) plan the $6,000 that represents Andy's deductible contributions and the growth gained in his traditional IRA. What is left in Andy's traditional IRA after the *roll-in* will be the $4,000 of his non-deductible IRA contributions. The same $4,000 held in Andy's traditional IRA can then be rolled over by Andy and converted into his new Roth IRA income tax-free since the remaining $4,000 represents only after-tax contributions to Andy's traditional IRA.

Caution: Not all qualified plan sponsors elect to permit the *roll-in* of pre-tax IRA dollars in their retirement plans. Some plans may have to be amended to permit this strategy to segregate pre-tax from after-tax dollars in a plan participant's traditional IRA to convert the balance to a Roth IRA tax-free.

Conclusion: Admittedly this is a narrow option to avoid incurring income taxes on a Roth IRA conversion. It requires a 'receptive' qualified retirement account that is willing to take *roll-in* pre-tax IRA dollars. The IRA owner also must accept the perceived less flexibility in investment choices offered by his/her employer's qualified plan. That said, if the goal is to create and fund a Roth IRA with all the perceived long-term tax advantages of a Roth IRA, then this strategy should be looked at by anyone who has a 'mixed' contribution traditional IRA.

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