



## Is Converting a Traditional IRA to Roth IRA Considered Income For The Bankruptcy Means Test?

### Question:

If a Traditional IRA is converted to a Roth IRA, is that action considered income for the means test in a Chapter 7 Bankruptcy filing?

### Answer:

For the benefit of readers, let's back up and understand why this question would even come up. A Traditional IRA is funded with pre-tax dollars; meaning the money you contribute to a traditional IRA is not taxed before you deposit it into the account. A Roth IRA is funded by after-tax dollars; meaning the money you contribute to a Roth IRA is taxed before you place it in the Roth IRA. The main benefit of a Roth IRA is that when you withdraw funds at retirement, the withdrawals are not taxed; whereas with a Traditional IRA, the withdrawals at retirement are taxable (the presumption is that in retirement you will be in a lower tax bracket, and therefore pay less tax at time of withdrawal). If you convert a Traditional IRA to a Roth IRA, an income event takes place for *tax purposes*. The IRS will take its cut because you are converting previously untaxed money and moving it into an investment vehicle that when you withdraw the funds at retirement, won't be taxed. So, when you convert a Traditional IRA to a Roth IRA, your tax return will show *conversion income*. A special note for 2010; if you convert in 2010, you don't claim the conversion income on your 2010 tax return, instead you get to split the conversion income on your 2011 and 2012 tax return.

I must admit, it's an interesting question and I can't say I have ever encountered this issue. However, all things being equal, a Traditional IRA to Roth IRA conversion should not push any debtor from a chapter 7 to a chapter 13 bankruptcy. Bankruptcy Code Section 101(10A) provides a very broad definition of *current monthly income* that includes everything except income derived from the Social Security Act and for victims of war crimes or crimes against humanity.



I would certainly argue that *conversion income* is **not** income for purposes of the means test because no new money is generated by the transaction. The debtor is merely exchanging one retirement instrument for another. You are converting one *asset* into another type of *asset*. In fact, a conversion only creates a new debt, a debt for income tax, Social Security, and Medicare. As such, in the larger context of the bankruptcy, the IRA conversion does not create a means to pay back creditors. You would want to disclose and explain the transaction, most likely under Question 10, Other Transfers, on the Statement of Financial Affairs (Form B-7), and you will be disclosing the asset on your Schedule of Assets and claiming the appropriate exemption.

Even if, by some chance, the conversion income is considered income for the Means Test, you still have *changed circumstances* argument that this one time event is just that; and going forward, the debtor has no way to fund a chapter 13 plan.

Lastly, one caution; if you do a Traditional to Roth conversion you need to make sure you do it correctly. Ideally, you want to do a Trustee to Trustee conversion; that is where the Trustee of your Traditional IRA directly transfers the funds to the Roth IRA Trustee. If that is not an option, and you receive a check from your Traditional IRA to deposit yourself, you only have 60 days to deposit the funds into a Roth IRA. If miss that deadline, the money loses its classification as *retirement* funds which could cost you the bankruptcy exemption and you could lost that money to the Bankruptcy Trustee.



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