

AI-04520 401K to Roth Conversion Double MD

Roth Conversion Guide for a Married Physician Couple (MFJ) – Fidelity 401(k)

A married physician couple is preparing to begin Roth conversions from their employer-sponsored 401(k) plans. They intentionally want to convert enough each year to remain within the 37% federal tax bracket (Married Filing Jointly).

Current retirement assets:

- Husband's Fidelity 401(k): Approximately \$600,000
- Wife's Fidelity 401(k): Approximately \$900,000
- Total 401(k) assets: Approximately \$1.5 million
- Both 401(k) accounts are currently held at Fidelity Investments.

Please create a comprehensive, step-by-step Best Known Method (BKM) for completing Roth conversions from scratch, assuming they have never performed one before.

Address the following questions in detail:

1. Do they each need to open a separate Fidelity Roth IRA, or can an existing Roth IRA be used?
2. Under what circumstances can a Fidelity 401(k) be converted directly to a Roth IRA?
3. Are they eligible for in-service Roth conversions, or must they wait until retirement or separation from service?
4. What accounts should be established before initiating the conversion?
5. What paperwork, online forms, or Fidelity website steps are required?
6. How should the Roth conversion be executed within Fidelity?
7. How can they determine the maximum dollar amount to convert each year while staying within the desired 37% MFJ federal tax bracket?
8. Should taxes be paid from cash outside the retirement account or withheld from the conversion proceeds? Explain the advantages and disadvantages of each approach.
9. What are the IRS reporting requirements (Forms 1099-R, 5498, Form 8606 if applicable, etc.)?
10. What common mistakes should be avoided during a Roth conversion?
11. Should the investments be transferred in kind (if permitted) or sold and repurchased? Explain Fidelity's process.
12. After the conversion, how should the Roth IRA investments be allocated? Assume they prefer a low-cost technology ETF such as FTEC.

3. What are the five-year Roth conversion rules and other IRS rules that apply?
4. Create a detailed checklist that can be followed every year for future Roth conversions.
5. Include a sample annual workflow beginning with tax planning, estimating taxable income, deciding the conversion amount, executing the conversion, paying estimated taxes, and maintaining documentation.

Assume the audience consists of financially sophisticated physicians who want to optimize long-term after-tax wealth while following IRS rules and Fidelity best practices.

This Best Known Method (BKM) guide outlines the strategic execution of Roth conversions for high-earning physician couples managed within Fidelity's institutional and retail ecosystems.

1. Account Setup & Ownership Structure

Account Ownership Rules

Under IRS rules, IRAs (Individual Retirement Arrangements) are strictly individual accounts. There is no joint ownership for IRAs or 401(k)s.

- **Mandatory Setup:** Each spouse **must open their own separate Fidelity Roth IRA** registered under their own Social Security Number (SSN).
- **Existing Roth IRAs:** If either spouse already owns an active Fidelity Roth IRA, that existing account can receive the converted funds. There is no requirement to open a new account for every conversion.

Prerequisite Accounts Before Conversion

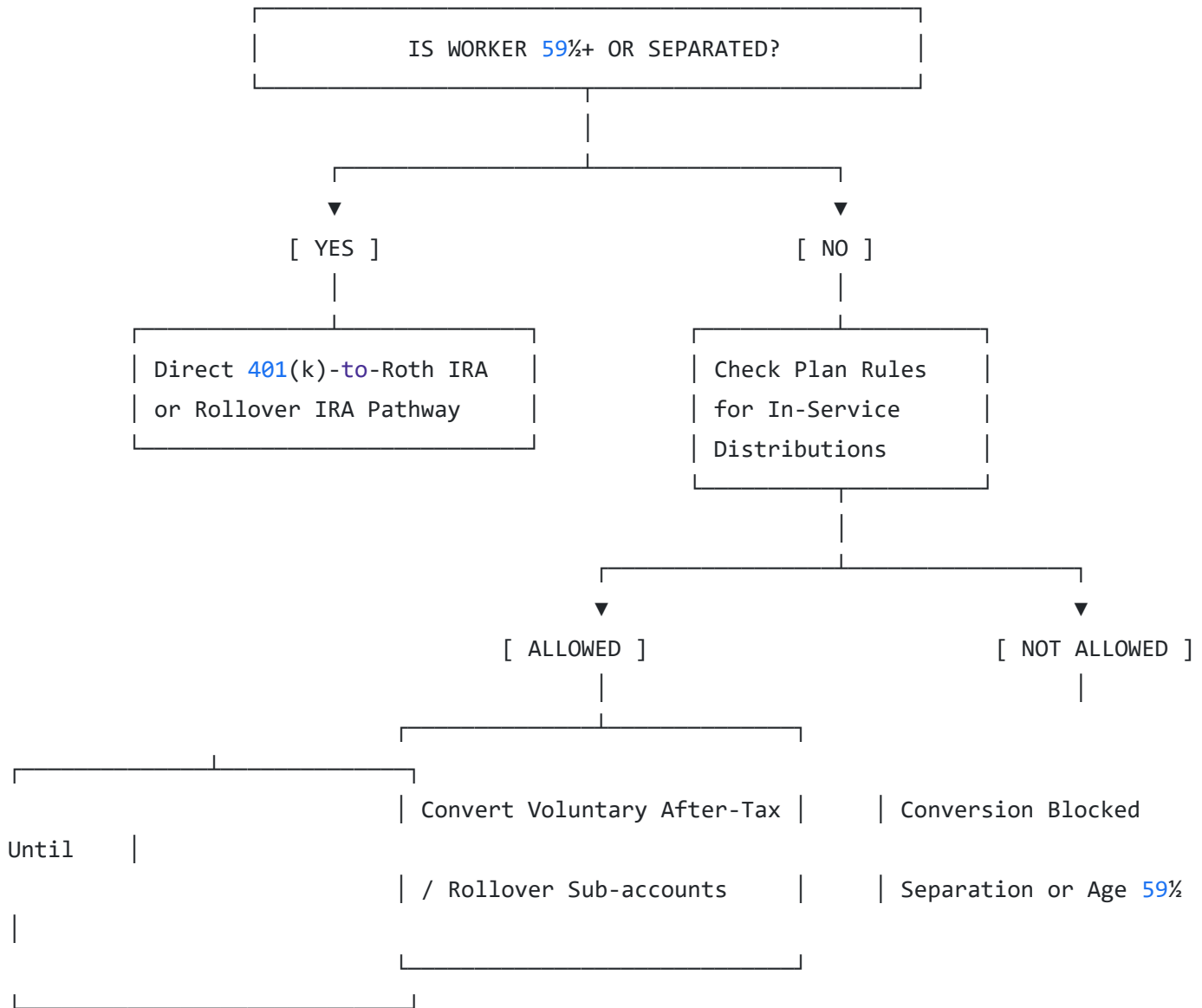
To execute this strategy smoothly without liquidating assets to pay taxes from inside the account, each spouse should have:

1. **Source Account:** Fidelity 401(k) / NetBenefits account.
2. **Intermediate Account (If Direct Conversion Is Unavailable):** Fidelity Traditional Rollover IRA (Individual).
3. **Target Account:** Fidelity Roth IRA (Individual).
4. **Tax Payment Source:** Fidelity Non-Retirement Joint Brokerage Account or High-Yield Cash Account (holding liquid cash for quarterly estimated tax payments).

2. Eligibility & In-Service 401(k) Conversions

Can a 401(k) Convert Directly to a Roth IRA?

Yes, but execution depends on whether the funds are eligible for withdrawal/transfer out of the 401(k) plan.



In-Service Distribution Rules

- **Active Employees Under 59½:** Employer plans typically restrict in-service distributions of active, pre-tax employee elective deferrals and matching contributions.
- **In-Service Exceptions:**
 1. **Age 59½ Provision:** Most Fidelity 401(k) plans permit in-service withdrawals once a participant reaches age 59½.
 2. **Rollover Sub-Accounts:** If either spouse previously rolled over funds into their current Fidelity 401(k) from a prior employer, plan rules often permit in-service conversion/withdrawal of

those specific assets at any age.

3. **Voluntary After-Tax Contributions:** If the employer 401(k) permits after-tax (non-Roth) contributions, these can be converted in-service immediately (commonly called the "Mega Backdoor Roth").

- **Separated/Retired Employees:** If either spouse has separated from service or retired from the employer sponsoring the 401(k), 100% of the account is immediately eligible for rollover and conversion.

3. Account Opening & Execution Steps (Fidelity Specific)

Step 1: Open Target Accounts

If target Roth IRAs do not exist, log into [Fidelity.com](https://fidelity.com) (retail portal, distinct from NetBenefits):

1. Navigate to **Open an Account** → **Roth IRA**.
2. Complete application under Spouse A's SSN.
3. Repeat step 1–2 under Spouse B's SSN.

Step 2: Determine Plan-Specific Conversion Pathways

Pathway A: Direct 401(k) to Roth IRA (NetBenefits Direct)

1. Log into **Fidelity NetBenefits**.
2. Select the 401(k) plan → **Quick Links** → **Rollovers** or **Withdrawals/Loans**.
3. Select **Start a Rollover / Distribution**.
4. Choose destination: *Fidelity Roth IRA*.
5. Select source sub-accounts (Pre-tax).
6. Specify the exact dollar amount calculated for the tax year.
7. Elect **0% federal and state tax withholding** (to pay taxes out-of-pocket).
8. Confirm electronic transfer directly into the corresponding Fidelity Roth IRA.

Pathway B: Two-Step Rollover (401(k) → Rollover IRA → Roth IRA)

If the 401(k) plan allows a full or partial rollover to an IRA, but does not offer direct online partial conversions to a Roth IRA within NetBenefits, execute the two-step process:

1. **Rollover to Traditional IRA:** Request an in-service or post-separation rollover from Fidelity 401(k) into a retail **Fidelity Rollover IRA** (pre-tax to pre-tax is a non-taxable event).
2. **Execute Roth Conversion on [Fidelity.com](https://fidelity.com):**
 - Log into retail [Fidelity.com](https://fidelity.com).
 - Go to **Transfers** → **Deposit, withdraw, or transfer funds**.
 - **From:** Fidelity Rollover IRA.

- **To:** Fidelity Roth IRA.
- Enter the exact conversion dollar amount.
- **Tax Withholding Election:** Select "**Do Not Withhold Taxes**" (0%).
- Review and submit. Processing completes within 1–2 business days.

4. Investment Execution: In-Kind vs. Liquidate & Repurchase

In-Kind Transfers vs. Cash Transfers

- **401(k) to Roth IRA Direct:** Institutional 401(k) plans hold plan-specific mutual fund share classes (e.g., institutional trust units) that **cannot exist inside a retail Roth IRA**. Consequently, Fidelity will liquidate the requested dollar amount to cash within the 401(k), transfer the cash to the Roth IRA, where it settles into the Roth core money market fund (e.g., SPAXX).
- **Rollover IRA to Roth IRA (Retail):** If converting from a retail Rollover IRA to a Roth IRA, **in-kind transfers are fully supported** for equities, ETFs, and retail mutual funds.

Trading Protocol for ETF Allocation (e.g., FTEC)

Because 401(k) conversions arrive in the Roth IRA as cash:

1. Once cash settles in the Roth IRA (Core Position), navigate to **Trade** on [Fidelity.com](https://fidelity.com).
2. Select **Symbol:** FTEC (Fidelity MSCI Information Technology Index ETF).
3. Select **Action:** Buy.
4. Select **Order Type:** Market Order (during market hours) or Limit Order.
5. Enter total dollar amount or share quantity.
6. Submit order.

Execution Tip: To avoid cash drag during market rallies, place the trade order as soon as cash settles in the Roth core account.

5. Tax Brackets & Optimizing the Conversion Amount

Understanding the Target Bracket Thresholds (MFJ)

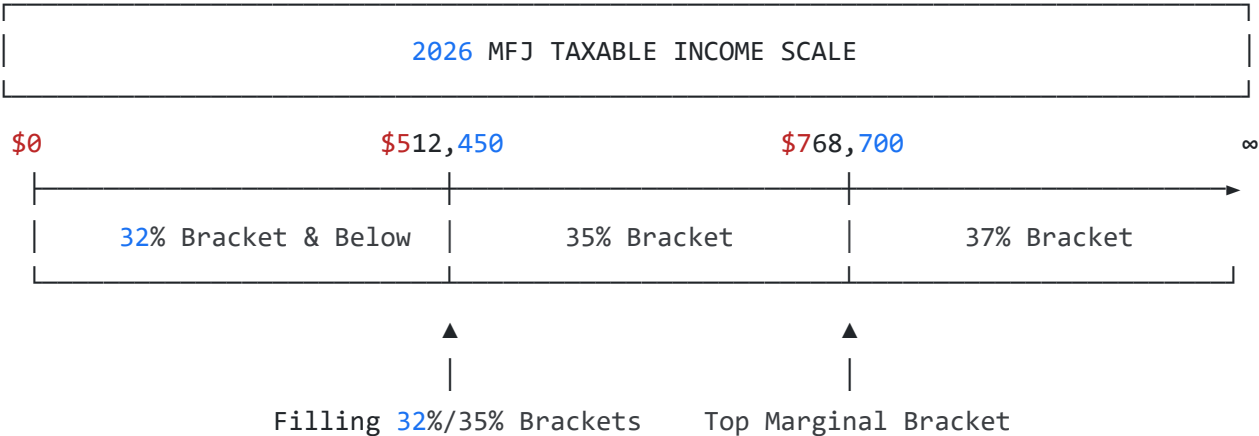
When targeting "remaining within the 37% bracket," note that the **37% rate is the top marginal federal tax bracket**. Converting within the 37% bracket means converting up to the maximum limit where the top rate applies, while avoiding pushing income into secondary surtaxes or alternative tax regimes.

For tax year **2026**, the relevant tax brackets for Married Filing Jointly (MFJ) are:

Federal Tax Rate	2026 MFJ Taxable Income Bracket
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32%	\$403,551 to \$512,450
35%	\$512,451 to \$768,700
37%	Above \$768,700

Standard Deduction (2026 MFJ): **\$32,200**.



Strategic Math: Filling the Brackets

If the primary goal is to fill up through the top of the 35% bracket (keeping all converted income taxed at or below 35% before hitting the 37% top rate):

$$\text{\$}\backslash\text{Max Conversion Target}\} = \text{\$}768,700 - \text{\$}\backslash\text{Estimated MFJ Taxable Income}\}\text{\$}$$

Example Calculation:

- **Gross W-2/Self-Employment Physician Income:** \$550,000
- **Less Above-the-Line Deductions & Standard Deduction (\$32,200):** -\$50,000
- **Estimated Taxable Income Before Conversion:** \$500,000
- **Top Threshold of 35% Bracket:** \$768,700
- **Max Combined Conversion Space (at $\leq$ 35% Rate):** $\text{\$}768,700 - \text{\$}500,000 = \text{\$}268,700$

If the couple intentionally wishes to convert **further into the 37% bracket**, there is no upper federal income ceiling. However, annual conversion caps should be planned based on **out-of-pocket cash availability** to pay the resulting tax bill.

6. Sourcing Tax Payments: Cash Outside vs. Account Withholding

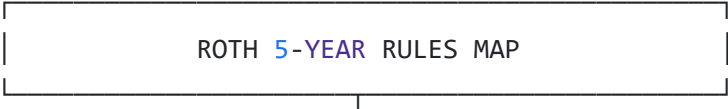
Strategy	Pros	Cons	Recommendation
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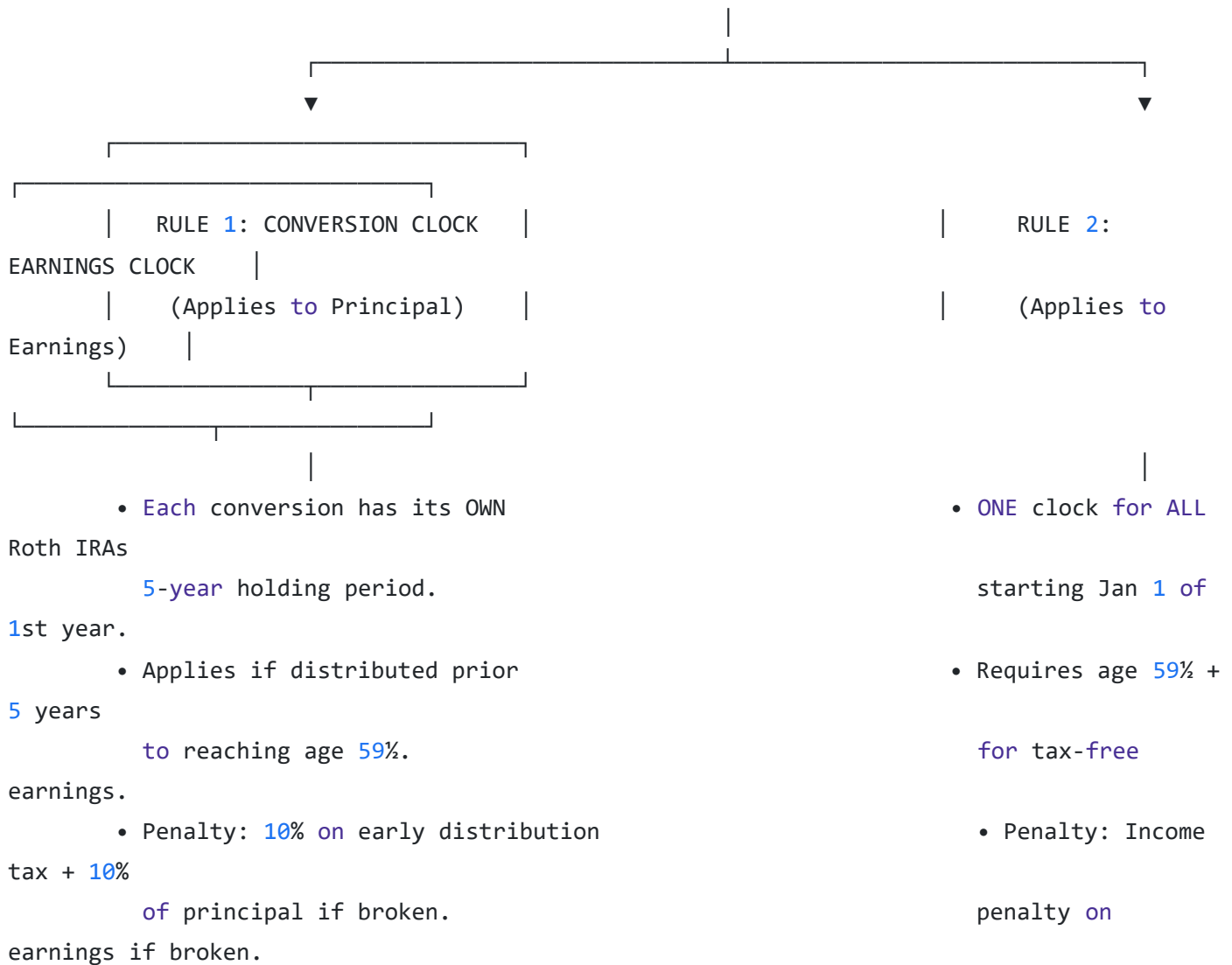
Option A: Pay Taxes from Non-Retirement Cash	• 100% of conversion proceeds enter the tax-free Roth environment. • Maximizes long-term compounding. • Avoids early withdrawal penalties.	• Requires substantial liquid cash reserves in taxable accounts.	MANDATORY BEST PRACTICE
Option B: Withhold Taxes from Conversion	• No out-of-pocket cash required at conversion time.	• IRS Penalty: Amounts withheld for taxes are treated as a <i>distribution</i>. If under age 59½, withheld funds trigger a 10% early withdrawal penalty (IRC §72(t)). • Permanently destroys tax-sheltered capital.	HIGHLY DISCOURAGED

Critical Rule: If either spouse is under age 59½, **never** withhold taxes from the conversion amount. Elect **0% withholding** with Fidelity and pay the tax via quarterly estimated tax payments from a taxable joint account.

7. IRS Rules & Five-Year Clock Mechanics

The Two Distinct "5-Year Rules"





1. The 5-Year Rule for Tax-Free Earnings:

- To withdraw growth/earnings tax-free, the Roth IRA must have been open for at least **5 tax years**, AND the account owner must be age **59½ or older**.
- The clock starts on **January 1** of the tax year for which the first Roth IRA contribution or conversion was made.

2. The 5-Year Rule for Conversion Principal (Under Age 59½):

- Each separate conversion** has its own distinct 5-year clock.
- If converted principal is distributed before 5 years have elapsed *and* before reaching age 59½, the 10% early withdrawal penalty applies to the distributed principal.
- Ordering Rules for Distributions (IRC §408A)*: Regular contributions come out first (tax- and penalty-free), followed by conversions (FIFO basis), and lastly earnings.

8. IRS Reporting & Tax Documents

At tax season following the conversion year, Fidelity and the IRS will exchange the following reporting forms:

IRS Form 1099-R (Issued by Fidelity in January)

- Issued separately for each spouse's account.
- **Box 1 (Gross Distribution):** Total amount converted.
- **Box 2a (Taxable Amount):** Typically shows total amount (or left blank/undetermined).
- **Box 7 (Distribution Code):**
 - Code 2 (Early distribution, exception applies) or Code 7 (Normal distribution if over 59½).
 - Code G (Direct rollover from 401(k) to Roth IRA).

IRS Form 5498 (Issued by Fidelity in May)

- Sent after the tax deadline.
- **Box 2 (Rollover contributions):** Reports total converted dollar amount received into the Roth IRA.

IRS Form 8606 (Completed with Tax Return / CPA)

- Filed with Form 1040.
- **Part II (2026 Form 8606):** Used to report conversions from Traditional/Rollover IRAs to Roth IRAs.
- Calculates net taxable conversion income and maintains historical basis tracking.

9. Major Pitfalls & Common Mistakes to Avoid

1. Pro-Rata Rule Pitfall (IRC §408(d)(2)):

- *Note:* Conversions executed directly from a 401(k) to a Roth IRA bypass the Pro-Rata rule.
- *Caution:* If performing conversions via an intermediate **Rollover IRA**, all pre-tax balance across **all** non-Roth IRAs (SEP, SIMPLE, Traditional IRAs) owned by that spouse is aggregated. If non-deductible basis exists, conversions are taxed proportionally across the aggregate balances.

2. IRMAA (Medicare Part B/D Premium Surcharges):

- Conversion income increases Modified Adjusted Gross Income (MAGI).
- MAGI triggers Medicare IRMAA surcharges on a 2-year lookback basis (e.g., 2026 conversions impact 2028 Medicare premiums).

3. Underpayment Penalty (IRS Form 2210):

- A large conversion mid-year increases tax liability. Without increasing wage withholding or submitting **Quarterly Estimated Payments (Form 1040-ES)**, underpayment penalties will apply.
- *Safe Harbor Rule:* Pay 110% of prior year's total tax liability (for AGI > \$150k) through withholding/estimates to eliminate penalties regardless of conversion size.

4. Failure to Track Individual Clocks:

- Mixing spouse accounts or miscalculating conversion dates across different tax years.

10. Master Annual Checklist & Workflow

Phase 1: Planning & Analysis (October – November)

- [] Aggregate year-to-date W-2 income, K-1 distributions, and 1099 investment income for both spouses.
- [] Determine total projected taxable income for the year.
- [] Reference current IRS tax bracket tables to pinpoint the upper bound of the target tax bracket.
- [] Calculate available "conversion space" ($\text{\$Upper Bound} - \text{\$Projected Taxable Income}$).
- [] Verify liquid cash balance in non-retirement joint account to pay estimated taxes.

Phase 2: Account Audit (Early December)

- [] Confirm active status of Spouse A Fidelity Roth IRA (or create one).
- [] Confirm active status of Spouse B Fidelity Roth IRA (or create one).
- [] Confirm 401(k) in-service withdrawal/conversion eligibility with Fidelity NetBenefits.

Phase 3: Execution (Mid-December)

- [] Submit Spouse A conversion order via Fidelity NetBenefits/[Fidelity.com](https://fidelity.com) (Select **0% withholding**).
- [] Submit Spouse B conversion order via Fidelity NetBenefits/[Fidelity.com](https://fidelity.com) (Select **0% withholding**).
- [] Confirm cash settlement into respective Roth IRA Core accounts within 2–3 business days.
- [] Execute purchase orders for target asset allocation (FTEC ETF) in both Roth IRAs.

Phase 4: Tax Compliance & Documentation (Q1 Following Year)

- [] Submit Q4 Estimated Tax Payment via IRS Direct Pay (by January 15) to satisfy safe harbor rules.
- [] Download Forms **1099-R** from Fidelity NetBenefits/Retail in late January.
- [] Deliver Forms 1099-R to CPA and verify inclusion of **Form 8606** on Form 1040 filing.
- [] Archive Form **5498** (received in May) in permanent financial files for basis tracking.

