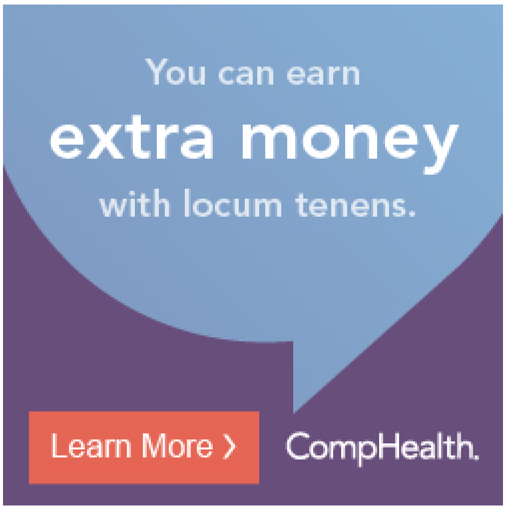
Rollovers, Transfers, Conversions Oh My! Learning the Vocabulary



An important part of medical education involves learning the vocabulary of the field. Think about how many new words you learned during Gross Anatomy alone! Medical vocabulary involves precise meanings for various words, and patients often don’t use them. How many times have we heard a patient say they have “heart pain” instead of chest pain and”kidney pain” instead of flank pain. Stomach and abdomen are interchangeable to many patients but to a doctor, they each have a precise meaning. That’s not even discussing the patients with fireballs in the eucharist, blood clogs, vomicking, and dryalysis.

The terminology in the financial world also has precise meanings, and if you want to understand how the financial world really works, it’s worthwhile learning them. Not only will it help you understand what is going on, but it will make you look smarter and hopefully you will be taken advantage of less. Let’s start with my pet peeve.

Rollover

Besides a command you give your dog, many doctors use the word rollover to describe any time money moves from one place to another. “I rolled over my traditional IRA to a Roth IRA” or “I rolled over my 401(k) to Fidelity.” However, a rollover has a very specific definition. A rollover is when a financial institution sends you a check from a qualified account, like an IRA or 401(k), and within 60 days you deposit that money into another qualified account at a different institution. Starting this year, you can only do one rollover per year. This law is to curb abuses where some people were constantly doing rollovers from one account to another, essentially enjoying the tax-free use of their money for whatever they wanted. However, rollovers are actually pretty rare. I move money around all the time, but I’ve never actually done a rollover. I generally do transfers, and you should too.

[Update 11/5/2015- I got hammered by readers in the comments section on this one. It turns out even the IRS uses rollover to describe any kind of transfer, whether you take possession of the money or not. It turns out my pet peeve wasn’t even real after all. How embarrassing!]

Parenting success is when your 6 year old and your 8 year old volunteer to change the newborn’s diaper

Transfer

A transfer is when the financial institution that has custody of your IRA transfers that money into an IRA at another financial institution without you ever getting your greedy paws on it. You can do as many of these as you want in any given year. The main downsides are that the paperwork takes a few minutes of your time, financial institutions tend to screw up transfers from time to time, and your money may be out of the market for a week or two, which obviously can be either bad or good, but since the market generally rises, is usually bad.

Conversion

A conversion is a special kind of transfer (or rollover) where you move money from a traditional IRA or 401(k) into a Roth IRA or Roth 401(k). This is a taxable event (although the tax bill may be zero, as with a Backdoor Roth IRA.)

Recharacterization

A recharacterization is what you do when you realize you really didn't want to contribute or convert to a Roth IRA but instead wanted to contribute to a traditional IRA, or not do a Roth conversion. One common reason to do a recharacterization is when you end up making more than the Roth IRA contribution limit but made a direct (instead of a backdoor) Roth IRA contribution. You have to recharacterize the contribution to a traditional IRA contribution. Some people also do recharacterizations if the market moves against them. For example, if you converted a $5000 IRA to a Roth IRA and invested it in the market, then the market dropped 20%, you could recharacterize the conversion. Then, after 30 days or the next calendar year after the conversion, whichever is later, you could reconvert it. That could save you hundreds of dollars in taxes due on that conversion, since the second conversion is only $4000 instead of $5000.

Contribution

You don't deposit money into retirement accounts, you "contribute" it.

Distribution

You don't withdraw money from retirement accounts, you "take a distribution."

There are dozens of other financial terms that are worthwhile to learn. Such as the difference between a fee-only and a fee-based adviser. (You pay both fees and commissions to a fee-based adviser.) 12B-1 fees, B shares, emerging markets, index funds, factors, spreads, wash sales, collars, commodities, MLPs….the list goes on and on. Learning all these terms is part of your Continuing Financial Education. The more familiar you are with the precise meanings of the vocabulary of the financial world, the less likely you are to make mistakes and to be taken advantage of.

What do you think? What financial terms do you see your colleagues misusing? Comment below!