Money Matters

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Skloff Financial Group 'Question of the Month'

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Q: Due to the new tax laws my 401(k) provider offered me the option of an In-Plan Roth Conversion. What is this and should I take advantage of it?

A: The Problem – New Tax Laws
Beginning in 2013, the American Taxpayer Relief Act (ATRA) unleashed a minefield of new taxes. While proper navigation can avoid these tax bombs and yield tax savings, one false move can trigger a series of tax bombs.

The Solution — Navigating the New Tax Laws
Buried in the new tax laws is an expansion of the 401(k) in-plan Roth conversion ("rollover") rules. Like the conversion of a Traditional IRA to a Roth IRA, an in-plan conversion converts tax deferred savings into tax free savings - the appeal of a conversion.

Until 2013, in-plan conversions were generally limited to plan participants that were 59 ½ years of age or older. The new law expands the conversion opportunity to all plan participants. Conversions are limited to plans that offer Roth deferrals and provide a conversion option. We review the Top 5 Most Frequently Asked In-Plan Roth Conversion questions below.

1. What makes pre-tax contributions, Roth contributions and converted assets different from one another?
With pre-tax contributions, income taxes are avoided today.
Upon withdrawal, contributions and earnings are subject to income taxes. With Roth 401(k) contributions, income taxes are paid today. Upon withdrawal, contributions and earnings are tax free. Once pre-tax contributions and earnings are converted, withdrawals of the converted amount and their earnings are tax free.
2. What are the primary tax implications of converting?
You may be subject to both federal and state income taxes on the conversion amount. The 10% penalty normally associated with a pre-age 59 ½ does not apply.
One of the most important considerations in evaluating a conversion is whether your income tax rate will be higher when you convert or when you withdraw the money. Recent increases in tax rates may be a foreshadowing of future increases in tax rates.
For many retirees their income tax rate is lower in retirement than in pre-retirement. But, as the cost of living continues to climb many 401(k) participants are contributing more so they can withdraw a larger amount to replace their income in retirement.
Generally, higher incomes are subject to higher income tax rates. For example, you may be subject to a 30% income tax rate today and a 40% rate in retirement. If your income is expected to be higher throughout your career and into retirement it may be advantageous to convert now, as it is better to pay 30% in taxes instead of 40%.
Since future tax rates are unknown, creating a tax free pool of retirement income is a form of tax diversification.
3. What are the secondary tax implications of converting?
The additional income from the conversion may trigger investment surtaxes on investment income, loss of tax credits and or deductions.
Thus, a partial conversion may avoid any secondary tax implications.
4. What estate planning benefits are provided by a conversion?
Generally pre-tax contributions and earnings are subject to IRS mandated withdrawals, called Required Minimum Distributions "(RMDs"), beginning at age 70 ½. Although Roth 401(k)s balances are generally subject to RMDs, retirees can rollover the assets to a Roth IRA account and avoid RMDs.
Avoiding RMDs and the taxes associated with them preserves the estate. Like Traditional IRAs, beneficiaries of Roth IRAs are subject to RMDs (spouses are exempt if they assume the IRA). [edit] Unlike Traditional IRAs, beneficiaries of Roth IRAs are not subject to income taxes.
5. Can a conversion be reversed?
While the conversion of an IRA to a Roth IRA can be reversed ("recharacterized'), an in-plan Roth conversion cannot be reversed.
This argues for delaying an in-plan Roth conversion until the end of the calendar year, when you can better determine your income and income tax rate.
Of course, this should be balanced with the risks of market timing (waiting until the end of the year, only to see a market run-up upon conversion).

Action Steps
Work closely with your Registered Investment Adviser to determine if a full or partial in-plan Roth conversion is an appropriate estate planning and tax diversification strategy for you.

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