Tax-Free Roth Conversions of 401(k) Plan Accounts

A change in retirement plan distribution rules has stoked new interest in non-Roth after-tax contributions ("After-Tax Contributions") to employer retirement plans by permitting after-tax amounts to be converted to a Roth IRA more easily.

Roth IRAs can be of value for retirement savers. But many high income taxpayers who are interested in a Roth IRA have limited or no access to them due to the IRS income limitations on contributions.* Of course, anyone can convert their traditional IRA to a Roth IRA and some 401(k) plans allow Roth contributions regardless of income, but now there is a new opportunity thanks to a surprisingly liberal new rule governing the rollover of After-Tax Contributions.

A recent IRS Notice put an end to the complicated multi-step process a retirement plan participant had to go through to convert after-tax balances in a retirement plan to a Roth IRA and successfully avoid a tax bill. This can be an opportunity for retirees with significant after-tax balances in retirement plans, and for that reason, many employers may have more of an interest in offering this contribution feature in existing plans. After-Tax Contributions are made from employee pay but are not considered Roth 401(k) contributions and are not tax deductible. However, they enjoy tax-deferred growth in a qualified retirement plan.

If your retirement plan account consists of both pre-tax and after-tax balances, any distribution (including rollovers) you take consists of a pro rata portion of each. Previously, if you used a direct rollover to convert all or some of your plan account to a Roth IRA, you had to include a portion of your pre-tax and after-tax plan balances in the conversion and include the pre-tax amounts in income. Now, when you roll over all or some of your plan account, the IRS will permit you to separate your after-tax balance in a direct rollover to a Roth IRA while you roll your pre-tax balance over to a traditional IRA. If your plan allows, and you qualify for an in-service distribution (not including hardship withdrawals), you may convert these amounts to Roth or traditional IRAs even if you are still working.

Of course, in order to make After-Tax Contributions, your plan has to allow for them. And your total annual contribution to the plan from all sources cannot exceed the maximum limit, which for 2018 is $55,000 plus an additional $6,000 "catch-up" for those age 50 and over. In that case, if you are under age 50 and contribute the maximum amount of pre-tax and/or Roth contributions of $18,500 to your 401(k), and your employer does not make any contributions (such as profit sharing or matching), you may contribute as much as $36,500 ($55,000 - $18,500 = $36,500) in After-Tax Contributions to your plan. If you are eligible for an in-service withdrawal, you may immediately rollover all or some of your plan account and convert the after-tax portion of the distribution directly to a Roth IRA.

**Married couples filing jointly with more than $199,000 and single taxpayers with more than $135,000 of Modified Adjusted Gross Income (2018) are precluded from making Roth IRA contributions.*

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It is important to note that these After-Tax Contributions are subject to the non-discrimination rules that 401(k) plans are required to follow (called the Actual Contribution Percentage test or ACP test). A plan that covers non-owner employees (i.e., common law employees) would have to pass this test, which limits highly compensated employee contributions to a small percentage more than the average amount contributed by non-highly compensated employees. However, for certain employers, such as a business with no common law employees who are eligible for the plan or one with just highly compensated employees, the test is not an issue.

Contact your Oppenheimer & Co. Inc. Financial Advisor to see if this new access to Roth IRAs is right for you.

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This is only one factor of the many factors that should be considered when rolling over a 401(k) plan.

The information provided herein is only one of the factors that should be considered before instituting a rollover from an employer retirement plan; there are potential advantages and disadvantages to an IRA rollover versus keeping your retirement savings in the plan. A retirement plan may have greater or lesser investments availability, fees or services. In addition, if you separate from service with your employer after age 55, IRS penalty free distributions are available, versus an IRA from which pre-59½ distributions are subject to IRS penalty, unless an exception applies. Employer plans that hold the employer's stock or other securities may have special tax provisions available for a distribution of the securities from the plan which do not apply to a distributions from an IRA. Finally, employer plans may provide greater protection from creditors, depending on the state in which you reside. For additional information regarding the pertinent advantages and disadvantages of the IRA versus the employer plan please contact your Oppenheimer Financial Advisor or a FINRA (Financial Industry Regulatory Authority) Investor Alert located at the following URL: http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/RetirementAccounts/P436001.

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