THE NEW SUPERCHARGED ROTH IRA PLANNING OPPORTUNITY

Clarity for an Increased Roth IRA Funding Opportunity

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Roth IRA accounts are among the most tax-favored savings vehicles available. While the annual limit to contribute to a Roth IRA in 2015 is $5,500 ($6,500 for those age 50 and older), as a result of an IRS Notice issued last fall you may be able to contribute substantially more through a "backdoor" approach to funding a Roth IRA. In fact, it may be possible for some to contribute in excess of $30,000 per year to a Roth IRA.

WHAT CHANGED?

Some companies' 401(k) plans allow participants to contribute both before-tax and after-tax dollars to their 401(k). In the past, there has been some ambiguity regarding whether or not one could ultimately segregate the pre-tax dollars from the after-tax dollars and roll over the pre-tax dollars to a traditional IRA and roll over the after-tax dollars to a Roth IRA, thus avoiding any income tax liability at the time of the transfers. IRS Notice 2014-54, "Guidance on Allocation of After-Tax Amounts to Rollovers," released on September 18, 2014, clarified that one can fully separate the pre-tax dollars from the after-tax dollars.

Note that this planning opportunity applies not only to 401(k) plans but also to 403(b) plans and some 457(b) plans.

WHAT IS A ROTH IRA, AND WHY IS IT SO BENEFICIAL?

Roth IRAs were first established as part of the Taxpayer Relief Act of 1997. Contributions to a Roth IRA along with earnings on these contributions grow tax-deferred within the account and are generally not subject to income tax when withdrawn. There is no income tax deduction when funds are contributed to the Roth IRA. And there is no requirement to take minimum distributions from a Roth IRA at age 70 ½. You can pass the Roth IRA upon death to an heir, who is then required to distribute funds out of the inherited IRA based on his or her life expectancy (but again, generally free of income tax). If you do not need income from these funds, a Roth IRA provides a way to compound funds tax-free for decades and then generally escape income tax when ultimately distributed from an inherited Roth IRA.

There are income limits that determine who is eligible to contribute directly to a Roth IRA. In 2015, married couples with adjusted gross income of $193,000 and single individuals with adjusted gross income of $131,000 are ineligible to make Roth IRA contributions. For married couples with modified adjusted gross income between $183,000 and $193,000 and for single individuals with adjusted modified gross income between $116,000 and $131,000, the amount of Roth IRA contributions is phased out proportionately within that income range.

In the past, some people made what are sometimes referred to as "backdoor" Roth IRA contributions. If their income was too high to contribute directly to a Roth IRA, they could fund a nondeductible traditional IRA and then convert the IRA to a Roth IRA. The tax problem with this strategy was that if they already had some traditional IRA accounts funded with pre-tax dollars they would incur a proportionate income tax liability when they converted the nondeductible IRA funds to a Roth IRA.

Also note that you may convert a traditional IRA to a Roth IRA, but this conversion is fully taxable. Note: In the past, if your income was $100,000 or more, you were ineligible to do a Roth conversion. But that limitation was eliminated as of 2010.

THE NEW PLANNING OPPORTUNITY

Based on IRS Notice 2014-54, one may be able to make sizable additional contributions to a Roth IRA if their employer's 401(k) plan allows for both pre-tax and after-tax contributions. If the plan does not allow for after-tax contributions then you will not be able to utilize this strategy. Note: The features of 401(k) plans vary significantly across plans, so it is imperative that you learn the exact features of your employer's plan.

How Much Can I Contribute? What Limits Am I Restricted By?

For plans that allow after-tax contributions, there are three restrictions that impact how much one is able to contribute on an after-tax basis:

1. Pre-tax limit for 401(k) plan contributions and Roth 401(k) plan contributions. In 2015, those under the age of 50 are subject to a contribution limit of $18,000. In addition, those age 50 or older are eligible to make an additional "catch up" contribution of up to $6,000.
2. Overall defined contribution plan limit. This limit is based on all contributions across defined contribution plans, including pre-tax and after-tax employee contributions, employer matching contributions and allocations of employee forfeitures by other employees. This limit in 2015 is the lower of $53,000 ($59,000 for those age 50 or older) or 100% of an employee's compensation.
3. Employer limit. 401(k) plans are subject to testing to ensure that the contributions made by higher paid employees do not exceed the contributions made by lower paid employees beyond specified amounts. Such testing can further limit how much an employee is able to contribute on an after-tax basis.

An Example

Let's assume a 40-year-old employee earning $90,000 annually contributes the maximum of $18,000 on a pre-tax basis to the company 401(k) plan. The company provides an employer matching contribution equal to 5% of annual compensation or $4,500. Also assume that this employee is not limited by any further limits by the firm and that the plan allows for both pre-tax and after-tax 401(k) plan contributions. In this case, the employee may make after-tax contributions of up to $30,500 in 2015.

Timing

Most people think of rolling over 401(k) plan funds at the time that they retire or terminate employment. But some employees may be able to roll over their after-tax contributions to a Roth IRA even while they remain employed by that firm if the plan provides for what is known as "in service withdrawals." Some plans allow for an unlimited number of in service withdrawals each year.

Note that you cannot roll over after-tax contributions without also rolling over the tax-deferred earnings on those contributions between the time the contributions were made and the time they are rolled over.

You also need to consider the impact of your pre-tax/after-tax contribution decision on employer matching contributions, and make sure that you are not losing out on any eligible portion of the employer match.

A Range of Planning Opportunities

There are a number of planning strategies that you may want to examine as a result of IRS Notice 2014-54:

- As previously discussed, consider contributing after-tax dollars to a 401(k) plan and then roll over those dollars to a Roth IRA, thus supplementing pre-tax or Roth 401(k) plan contributions along with any eligible direct Roth IRA contributions.
- If you do not have access to a designated Roth 401(k) and if your 401(k) plan allows for it, consider contributing 100% of your contributions on an after-tax basis and eventually rolling over these funds to a Roth IRA. In this way you can approximate being able to fund a designated Roth 401(k) without actually having this option available. This approach is especially worth considering if you expect your marginal income tax bracket to be higher over time.
- If you have access to a non-qualified deferred compensation plan (NQDC), consider funding after-tax dollars to a 401(k) plan ahead of the NQDC plan. NQDC dollars ultimately will be taxed, while after-tax 401(k) plan contributions rolled over to a Roth IRA will not be taxed.
- It may make sense to consider contributing some amount of after-tax dollars to a 401(k) plan and rolling over the contributions to a Roth IRA instead of contributions to a 529 plan for education.
- For families looking to maximize wealth over multiple generations, planners previously recommended that parents consider providing funds so their children in their teens and 20s could open Roth IRA accounts based on any earned income the children had. With this clarified opportunity, the older generation may want to provide funds as needed so that their children and grandchildren have sufficient cash flow to maximize both pre-tax and after-tax retirement plan contributions. The older generation can consider utilizing their $14,000 annual gift exclusion per donee along with intra-family loans made at today's low interest rates to provide this funding.

POTENTIAL LEGAL CHANGES

We have begun to see some comments out of Washington, D.C. about potentially limiting the ability of high-income employees to utilize certain retirement plan strategies. This is a topic that will need to be monitored over time relative to the ability to continue utilizing the planning techniques discussed in this paper.

FOR MORE INFORMATION

There is a great deal of variation across the 401(k) plans offered by various employers. It is imperative that one fully research the features of their own company's plan before pursuing any of the strategies discussed above. In addition, all tax planning ideas should be vetted by your own tax counsel to determine how these strategies relate to your own personal financial situation.

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