Converting after-tax contributions to a Roth IRA

There are several income tax avoidance strategies that can be employed when planning for retirement

Taking retirement distributions tax efficiently, and positioning retirement assets in the right retirement plan, may help to minimize income tax and maximize income during the retirement years. It can be advantageous to move money from an employer-sponsored plan or individual retirement plan to a Roth IRA. More specifically, an attractive strategy for after-tax contributions contained in an employer-sponsored plan, or a traditional IRA, may be to move these assets to a Roth IRA. The conversion rules for after-tax employee contributions and other not-designated-Roth after-tax amounts were clarified by Internal Revenue Service Notice 2014-54.

Some employer-sponsored retirement plans, such as 401(k) plans allow employees to make payroll deduction after-tax contributions and earn tax-deferred growth on these contributions. After-tax contributions are normally made when the 401(k) elective deferral limit has been reached. When the amount contained in the after-tax account is eventually distributed from the plan to the participant, the amount equal to the after-tax contributions is not taxable since it was contributed on an after-tax basis. However, the earnings realized on after-tax contributions are subject to current income tax when distributed and received unless the distributed earnings are rolled over to an eligible retirement plan such as an IRA or other qualified plan.

After-tax employer-sponsored plan provisions and contribution limits

The employer-sponsored plan must have provisions for a plan participant to make after-tax contributions. Not all employer-sponsored plans have this provision. After-tax contributions, like 401(k) elective deferrals, are subject to discrimination testing rules. There are limits on the amount of after-tax contributions that can be made to a plan (normally a percentage of pay limit). In addition to the percentage limit, there is an overall annual contribution limit that applies to all contribution types, such as 401(k) deferrals, matching contributions and/or profit-sharing contributions to a defined contribution plan.

Distribution of after-tax contributions and earnings

The Tax Reform Act of 1986 changed the rules regarding how the after-tax contributions and the related earnings are recovered when distributed. If after-tax contributions were made prior to 1987, they can be taken out of the plan before the earnings, providing the plan separately accounts for them. This will permit the plan participant to only receive their contributions first and any earnings related to the after-tax contributions second. If after-tax contributions were made after 1986, they come out of the plan with a proportionate amount of earnings. Notice 2014-54 clarified that a distribution of post 1986 non-Roth after-tax contributions can be directly rolled over to the Roth IRA as a non-taxable conversion, and the related earnings can be directly rolled over to a traditional IRA.

Example

A plan participant has an account balance of $200,000 consisting of $150,000 in pretax amounts and $50,000 in after-tax amounts made to the plan after 1987. The plan separately accounts for after-tax contributions, and has a provision for an in-service distribution. A partial distribution of $100,000 would contain a pretax amount equal to $75,000 and an after-tax amount equal to $25,000. The plan participant may direct the pretax amount be directly rolled over to a traditional IRA rollover and the after-tax amount directly to a Roth IRA as a conversion to a Roth IRAs. There would be no current tax on the portion rolled over to the traditional and no current income tax on the conversion, since it is entirely after-tax money. Both the traditional and Roth IRAs will provide tax-deferred growth. The Roth IRA distributions may become qualified distributions where the after-tax amount is not taxable on any distribution, and the earnings also avoid taxation. Certain requirements must be met to have a qualifying distribution from a Roth IRA.

Conversion of non-deductible traditional IRA assets to a Roth IRA

This strategy is also known as the backdoor Roth IRA. Some individuals are not eligible to make regular Roth IRA contributions (with respect to compensation) because modified adjusted gross income is too high. In this situation, a backdoor Roth IRA may be worth consideration. Because there are no longer modified adjusted gross income limits on conversions, non-deductible contributions contained in a traditional IRA can be converted to a Roth IRA, providing that all IRAs are treated as one IRA. If an individual converts their only traditional IRA containing non-taxable amounts to a Roth IRA, there would be no taxation with the conversion. However, if an individual has one or more IRAs and wants to do a partial conversion, the IRAs must all be aggregated and treated as one. If there is pretax money in any of the IRAs, this would result in a taxable conversion.

Example

An individual has one traditional IRA containing non-deductible (after-tax) contributions that equal $5,000 and no earnings. The individual has no other IRAs. The individual converts to a Roth IRA. There is no tax due on the conversion since the amount converted is all non-deductible money.

Example

An individual has two traditional IRAs. One contains deductible (pretax) contributions and earnings totaling $95,000, and another IRA contains non-deductible contributions with no earnings equal to $5,000. The individual decides to convert the $5,000 non-deductible IRA to a Roth IRA. The aggregation rules require both IRAs be treated as one IRA. This would be considered a partial conversion, and there would be a pro-ration to determine what portion of the $5,000 is taxable and non-taxable. The pro-ration rules require 95% of the $5,000 ($4,750) as taxable and 5% of the $5,000 ($250) as non-taxable.

Roth IRA conversion advantages

The amount converted to the Roth IRA can accumulate tax-deferred income. Providing the distribution from a Roth IRA is a qualifying distribution, not only will the amount converted avoid income tax, the earnings accumulated inside the Roth IRA will also avoid taxation. Another advantage with moving after-tax assets to the Roth IRA is there are no lifetime required minimum distributions as with traditional IRAs. (There are post-death required minimum distributions for Roth IRA beneficiaries.) After the passing of the Roth IRA owner, an individual named as the beneficiary may be eligible to receive a tax-free death benefit, taken either in a lump sum or over their life expectancy.

Note

The opportunity to prepare for retirement by making after-tax contributions to a qualified plan or making non-deductible regular contributions (with respect to compensation) to a traditional IRA and then converting to a Roth IRA is not always available and/or possible for everyone. But when it is available, there is a very compelling argument to take advantage of this opportunity.

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