A New Option for Roth

So the 'fiscal cliff' is history now with the passage of American Taxpayer Relief Act (ATRA), but your administration system may need some updates very soon to support new Roth processing.

When Roth IRAs were first introduced in January 1998, they provided savers a unique alternative to the already existing traditional IRA. Unlike the traditional IRA, on which contributions were and still are deductible from income tax (with some exceptions), the Roth IRA disallows a current year tax deduction in exchange for possible 100% tax free distributions in the future. *If the investor follows the rules and leaves the money intact for at least five years and attained age 59 and ½, then 'qualified' withdrawals of original investment amounts and any earnings are 100% tax free.*

Too good to be true, right? Well the 'fine print' for individual Roth IRAs includes restrictions on contributions based on income limits. In general, if the household income in a tax year exceeds a threshold, then a contribution is phased out or not allowed at all.

Years after the introduction of the Roth IRA, Congress changed Roth regulations to allow 'conversions' from existing traditional IRAs into Roth IRAs. In the process, the owner paid income taxes on the converted amounts. This was welcome news to some IRA owners with large balances – except again there were annual household income limits that if exceeded would disallow Roth conversions.

In the last few years, Congress again loosened the rules to allow conversions from traditional IRAs into Roth IRAs without any household income limits. No doubt a revenue-starved Federal government was pleased to see the tax revenue coming in from these conversions. However, the rules were directed primarily towards individual IRAs and not the few employer qualified plans at the time that included designated Roth accounts.

ATRA allows all participants in company 401k, 403b and 457 plans that have Roth designated accounts to do expanded in-plan conversions. Prior to this new law, any in-plan conversions were allowed only if the participant was eligible to take a distribution – which translated to being at least age 59 and ½, deceased, disabled or separated from service, unless the plan allowed in-service withdrawals (rare). The pre-ATRA law essentially disallowed younger plan participants without a rare exception to take advantage of Roth conversion. The new law does not discriminate based on age and allows workers to decide when to take 'the tax bite' on existing balances in a 401k/403b/457 plan that are currently classified as pre-tax by converting them to Roth designated accounts.

Hamilton Smith Associates anticipate that intra-plan conversions may have unique reporting codes, so we expect administrative change details to come out soon on 1099R reporting. One warning on these conversions – unlike individuals IRAs where a Roth conversion can occur and an owner can later change their mind and recharacterize back to the original traditional IRA, employer in-plan conversions as of this moment are described to be 'one way'. This means once done, a participant cannot change his or her mind. We expect there to be exceptions that come out for this as well since in the 'real world', exceptions happen. Or legislation may be intentionally revised later to allow for recharacterization. So stay tuned for more rules to be configured and deployed in your administrative processes.

Visit: HamiltonSmithassociates.com or contact:
Dan Smith, President
email: Dan.Smith@hamiltonsmithassociates.com