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Ask Kidder.

Converting to Roth?

Recently, a client determined he would lose about one million dollars in his business for the year. This was a one-time setback, and he expected to be back on his feet the next year. Coincidentally, this "S" Corporation business owner also had an account balance over $900,000 in his 401(k) profit sharing plan. After discussing and confirming the situation with his tax advisor, he converted his entire balance to Roth. The amount converted was taxable on Form 1040, but the business loss offset that taxable income, eliminating the negative tax consequences. In this case, Roth worked well.

On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012, which included a new Roth provision, allowing in-plan Roth transfers or conversions. This was welcomed by the retirement plan community, because it made the conversion process easier. But the intent of the provision was to increase tax revenue and pay for a two-month suspension of automatic government spending cuts. In a conversion, participants receive a Form 1099-R to report the amount converted as ordinary income for tax purposes.

Prior to 2013, in-plan Roth rollovers were available, but only for accounts eligible for in-service distributions. As a result, few plans adopted the in-plan Roth rollover provision. This new Roth conversion option is only available if your qualified plan has a Roth deferral option. But plans can be easily amended to allow it.

The new option applies to all account types (deferral, match, safe harbor, QNECs, QMACS, profit sharing, etc.). It is also available even for participants not eligible for an in-service distribution. But before any conversion occurs, it is important to understand that each individual situation is unique. The decision is irreversible. Thus, a competent, well-informed tax advisor should be involved before making a Roth conversion.

What are the Advantages of Roth?

Under current law, a Roth account balance creates several advantages.

- Certain eligible distributions of Roth amounts, including earnings which have never been taxed, are not subject to income tax when distributed.
- If the future marginal tax rate that applies to your situation is always higher than your current marginal tax rate, a tax advantage occurs for current Roth conversions and current Roth deferrals.
- An employer retirement plan must begin minimum distributions at age 70½, even for the plan's Roth accounts. However, if the Roth plan account is rolled over to a Roth IRA, the Roth IRA is not required to begin minimum distributions at age 70½.

Any Disadvantages?

Since a Roth conversion is an irreversible, long-term financial decision, there are potential downsides.

- Will the current law stay the same? Will Roth accounts truly remain tax-free? A Roth decision is long-term, and Congressional budgeting is short-term. We were once told that Social Security will never be taxable, since it is "merely a return of our taxes already paid."
- If future tax rates are lower than the tax rates that now apply to current Roth conversions and Roth deferrals, then a pre-tax account would generally be a better option than a Roth.
- The tax reporting rules for this new conversion option are not yet released by the IRS. Also, other issues are awaiting IRS guidance, such as whether the conversions are limited only to vested account balances.

These concerns should not prevent anyone from considering Roth, but should at least be added to the list of factors involved in the Roth decision.

For additional information on Roth advantages and disadvantages, please review pages 2 and 3 of our October 2010 newsletter.

Can an Amendment be done now?

Currently, no guidance is available from the IRS. Until such time, eligible plans can make the Roth conversion feature available to plan participants with the understanding that an amendment will need to be adopted by the end of 2013 or later date determined by the IRS. If you wish to take advantage of this new provision, please contact your Primary Administrator.

Watch for our next issue!

Coming up in our next newsletter, Cash Balance plans will be examined. Doug Lane, President of Kidder-Lane Actuarial Services, LLC., wrote an article that was recently published in the Summer 2013 issue of ASPPA's *Plan Consultant* magazine. Doug's article, "Maintaining DB Plan Viability via Cash Balance Plans" provides a glimpse into the realm of Cash Balance plans. Kidder-Lane and Kidder Benefits are national leaders in designing and administrating Cash Balance plans as well as combining 401(k) plans with Cash Balance plans.