

Using a Roth Conversion to Minimize Future Income Tax Exposure

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With the increase in Medicare taxes that goes into effect in 2013 and the high likelihood of increased tax rates in one form or another as a result of the “fiscal cliff” negotiations, individuals may want to consider accelerating income into 2012 to avoid additional income tax exposure in 2013 and beyond. One way to accomplish this is through the conversion of funds in the individual’s traditional individual retirement account (IRA) to a Roth IRA. A Roth conversion may also be transacted within an employer-sponsored 401(k) retirement plan, if the plan’s terms permit it. Under this “in-plan Roth rollover,” a plan participant can transfer all or part of his vested non-Roth account to a designated Roth account within the same plan. The amount converted is subject to federal income taxation in the year of conversion (except for any non-taxable basis in the converted amount), and, therefore, the participant must have funds available to pay the taxes due. Once converted to a Roth account, the converted amount is treated as “after tax” and is not subject to further taxation when distributed in the future. If the distribution is a “qualified distribution” (generally, on or after the participant attains age 59 ½ and after having a Roth account in the plan for five years), earnings that have accrued on the Roth amounts may also be distributed tax free. An attractive feature of the in-plan Roth rollover is that its availability is not limited to individuals below a particular income level; instead, it is a tax benefit that can be available to all of an employer’s plan participants, if the plan’s terms allow for it and the plan’s record keeper is able to administer it.