By DAVID J. SCHILLER, JD, LLM

Tax law changes offer new Roth opportunity

Buried in the new tax law is a great opportunity to reduce the amount of taxes you'll have to pay when you start withdrawing funds from your 401(k) or 403(b) plan—provided you're willing to pay taxes on the money now.

First, some background: In 2006 Congress authorized the creation of Roth 401(k) plans. These plans are similar to Roth individual retirement accounts (IRAs). Unlike standard 401(k) plans or IRAS, where you are taxed on the funds when you begin withdrawing them, Roth plan contributions are taxed at the time you make them.

LETTING ASSETS GROW TAX-FREE

The advantage of converting to a Roth plan is that the assets in a Roth can grow tax-free, and any withdrawals made after age 59½ and that have been in the plan for at least 5 years are not taxed.

Until now, tax-free withdrawals were allowed only on the funds that you, the employee, contributed, not on any employer match or profit-sharing plan contributions. As part of the new tax law, however, you can now convert or recharacterize all the funds in your 401(k) plan, including employer match and profit-sharing, into a Roth account, provided that your employer's plan permits Roth conversions. Doing so will allow these funds to grow tax-free until you withdraw them.

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Remember also that for the funds in your plan to receive tax-free treatment, they must remain in the plan for at least 5 years and you must be at least 59½ years old when you withdraw the funds. The 5-year clock starts ticking when you make your first Roth 401(k) contribution or recharacterization. Therefore, if you are in your 50s or older, you should consider doing a Roth conversion immediately if this option appeals to you.

These new provisions also apply to 403(b) plans, so if you are employed by a hospital or educational institution and participate in its 403(b) plan, check to see whether it permits in-plan conversions.

PROS AND CONS OF A ROTH CONVERSION

If your plan is modified to permit such conversions, does it make sense to do so? A Roth conversion makes the most sense if you're not going to need your money for many years. You also need to factor in your likely future tax rate. The greater your assets during retirement, the higher your likely bracket and the more that converting now makes sense.

On the other hand, if you don't have sufficient other funds to pay the taxes due on conversion, then converting probably does not make sense. The same is true if you anticipate little income during your retirement years.

An alternative to converting the entire employer plan balance is to consider doing partial conversions over several years. Doing so would help alleviate the impact of higher income on your tax return and reduce the effect on your tax rate, credits, alternative minimum taxes, and deductions.

Any funds converted in 2013 would be subject to current ordinary income tax rates. Because tax brackets are still relatively moderate and higher rates in the future are a distinct possibility, now may be the perfect time to consider converting some or all of your pre-tax retirement plan assets.

If conversion makes sense for you, then contact your attorney or financial planner and ask him or her to amend your plan to include the necessary language so that you can take advantage of this new opportunity.

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