YOUR TAX-FREE ROTH BUCKET

Adding Roth assets to an IRA or your employer's retirement plan usually involves a trade-off. Roth assets can grow and be withdrawn tax-free – a valuable future benefit. But making after-tax Roth instead of pre-tax contributions means missing out on up-front tax benefits. And converting pre-tax assets to Roth assets means paying up-front taxes sooner than you need to. Navigating the trade-off can be challenging but owning Roth assets may make sense for tax diversification and planning reasons.

Roth benefits

Roth assets that are qualified — owned for at least a five-year period when you are over age 59½ — provide tax-free income[1] and also help you minimize taxation of Social Security benefits and avoid Medicare premium surcharges.

Roth IRAs have some added benefits:

- Contributions can be withdrawn at any time without taxes or penalties.
- IRS required minimum distributions (RMDs) do not apply. (Note: 457/401(k) Roth assets could later be rolled over to a Roth IRA to avoid RMDs.)

Roth assets are more likely to benefit you if you:

- are in a lower tax bracket now and likely to be in a higher one later when you take withdrawals.
- are young, allowing more time for tax-free assets to build up.
- want to minimize RMDs
- want to pass on tax-free assets for loved ones. NOTE: RMDs do apply to inherited Roth assets.

Diversifying your tax situation

Predicting your future economic and tax situation is difficult. And tax rules are uncertain, too. Changes Congress may make to tax laws could result in various outcomes, including:

A increasing tax rates, which could make Roth assets particularly valuable.

B increasing the tax base by removing exclusions and deductions, but keeping overall tax rates even or lowering them, which could make Roth assets slightly less valuable.

C reducing Roth tax-free benefits, which could make Roth assets less valuable.

Roth assets may help you diversify your taxes like you diversify your investments because they give you greater flexibility to manage your future tax bills. Owning assets that are taxed differently means that you can pull from different sources based on what makes the most sense tax-wise in a given year.

EXAMPLE: in a particular year when you have unusually large expenses, you can withdraw extra Roth assets to avoid being pushed into a higher tax bracket.

Adding Roth assets

You should consider consulting a tax professional for advice specific to your situation, but if owning Roth assets makes sense, a few options may be available to you.

1 Roth IRA contributions, assuming you are eligible based on your income.[2]

2 457 or 401(k) plan Roth contributions if available to you.

COMPARING 457 OR 401(K) ROTH ASSETS TO A ROTH IRA

Roth IRA Pluses	Employer Plan Pluses
More flexible withdrawal rules	Higher contribution limits
No RMDs	No income limits for contributions
Ability to recharacterize conversions	May offer higher creditor protection

NOTE: You should also compare the investment options, services and fees between the two accounts.

3 Roth IRA conversions, in which you transfer traditional IRA or eligible employer plan assets to a Roth IRA.

Because the amount converted is subject to income taxes, the decision is more complex.

- First, you should have available non-retirement money to pay the taxes; draining retirement assets to pay them will likely offset any future benefit.
- Also, for that particular tax year, the conversion could lead to paying taxes at a higher rate, a loss of tax deductions or credits, taxation of Social Security benefits, Medicare premium surcharges, or a reduction in college financial aid.

But a conversion may pay off if you're in an unusually low tax bracket one year, or if you spread out your conversions over a few years, converting only enough to keep you in a relatively low tax bracket. And the longer you take to withdraw converted assets, the more likely you will come out ahead because you allow more time for those assets to grow tax-free and offset the taxes paid.

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Recharacterizing a Conversion. Once a Roth IRA conversion is completed, you have the ability to recharacterize, or undo, it before that year's tax-filing deadline, including extensions.

EXAMPLE:

- You convert $10,000 traditional IRA assets to a Roth IRA in December 2015, which then decline in value to $7,500. But you still owe taxes on the entire $10,000.
- You have until October 15, 2016 to undo the conversion, moving the applicable assets back into the traditional IRA, and no longer owe taxes on it.

4 In-plan 457 or 401(k) Roth conversions

Your employer's plan may allow you to convert pre-tax assets to Roth assets without taking the money out of the plan. Unlike Roth IRA conversions, in-plan conversions cannot be recharacterized.

5 Convert after-tax 401(a) or 401(k) contributions to a Roth IRA

Eligible after-tax contributions made to a 401(a) or 401(k) plan can also be converted, but tax-free, as long as all pre-tax assets are rolled over to a traditional IRA or to another employer-sponsored plan at the same time.

EXAMPLE:

- You own $10,000 after-tax + $20,000 pre-tax contributions
- You can transfer the $10,000 after-tax directly to a Roth IRA tax-free, if you transfer the remaining $20,000 to a traditional IRA as part of the same distribution.

NOTE: any earnings are associated with after-tax contributions are subject to tax.

Can you apply this same strategy to after-tax (non-deductible) traditional IRA contributions? Generally no, because any assets taken out of a traditional IRA, whether a distribution or conversion, are considered to be proportionately pre- and after-tax sources in all of your IRA accounts.

EXAMPLE:

IRA 1 = you own $10,000 non-deductible contributions + $10,000 earnings = $20,000

IRA 2 = you own $10,000 deductible contributions + $10,000 earnings = $20,000

- Your after-tax contributions ($10,000) are 25% of your total IRA assets ($40,000)
- So each dollar taken out is considered 25% after-tax and 75% pre-tax.
- If you convert $10,000 to a Roth IRA, $7,500 would be subject to tax.

EXCEPTION: If you participate in a 401/457 plan that accepts rollover of IRA assets, since after-tax IRA assets can't be rolled over to them, you could:

- Roll over $30,000 IRA pre-tax contributions and earnings to the 401 or 457 plan
- Convert or rollover the $10,000 remaining IRA after-tax assets to a Roth IRA.

Making your decisions

1 Evaluate the pros and cons of adding Roth assets.

- Compare your current and expected future tax rates and your current mix of Roth, pre-tax, and other assets.
- Visit www.icmarc.org/rothanalyzer for a breakdown.

2 Explore the pros and cons of Roth contributions vs. conversions, and of adding Roth assets in your 457 plan vs. a Roth IRA.

- It may make sense to choose pre-tax 457 and Roth IRA contributions. Adding 457 plan Roth contributions to the mix may also be preferable.
- Converting small amounts over time can help avoid pushing you into a higher tax bracket.
- Visit www.icmarc.org/whichira and www.icmarc.org/rothconversion for more information about IRA rules.

3 Take action if Roth makes sense for you.

- If you have an ICMA-RC 457 or 401(k) account that allows Roth contributions and in-plan conversions, obtain the necessary forms from your employer's benefits office, by visiting www.icmarc.org/forms, or by contacting your ICMA-RC representative.
- To learn more about an ICMA-RC Roth IRA, visit www.icmarc.org/ira.

[1] *Roth distributions are also tax-free due to a qualifying disability or, in the case of a Roth IRA, for qualifying "first-time" home purchase. Distributions that are not qualified are subject to income and possibly penalty taxes. For more information, see IRS Publication 590.*

[2] *Visit www.icmarc.org/whichira or IRS Publication 590 for more information on contribution limit rules.*

ICMA-RC does not provide tax advice.