

## **Facts**

We recently had one of the participants in our 401(k) plan ask if it is possible to convert her balance from pre-tax to Roth. She has been a participant in our plan for many years and has both her own deferrals as well as company contributions (both match and profit sharing). Based on her current financial situation, she believes it would be more advantageous to convert to Roth so that she can receive distributions tax-free when she retires.

# Question

Is it possible to convert the current pre-tax accounts inside the 401(k) plan to Roth accounts?

## **Answer**

For a change, that question has a straight-forward answer, and it's the answer you want! The answer, quite simply, is yes. Of course, your plan's legal document must have that option selected in order for any of your participants to use it. If that provision is not selected, it is a fairly easy process to amend your plan to add it.

## Why Convert?

Converting pre-tax deferrals to Roth can be advantageous for employees who believe that their tax bracket will be much higher when they retire than it is now. This allows the participants to pay taxes at a lower rate now and then withdraw their retirement accounts later when they are in a higher tax bracket. It can also be advantageous for younger employees who have many years for their retirement savings to accumulate. It is not unusual for investment gains to make up a significantly larger portion of the overall account than contributions over such a long time horizon. Since Roth accounts offer the ability for tax free withdrawals, including those accumulated investment gains, converting to Roth in the earlier years of a career can really boost the future value.

#### How Does the Conversion Work?

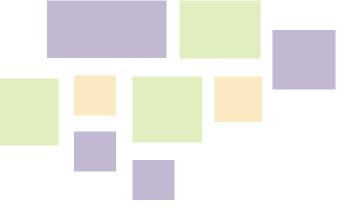
Here is where things get slightly convoluted. There are Roth conversions and Roth transfers. Conversions are only permitted when a participant otherwise has a reason to take money out of the plan. That could be on termination of employment or attainment of age 59 ½. Transfers, on the other hand, are not restricted to those types of events, so any participant can take advantage of them. The rest of this post will focus on transfers.

Fortunately, that explanation is the most complicated part. Once the participant formally makes the election to transfer from pre-tax or Roth (presumably using a form provided by the plan's recordkeeper), the recordkeeper moves the amount from the current pre-tax accounts in the plan to Roth accounts in the plan. For example:

Pre-Tax Deferrals -> Roth Deferrals

Employer Match -> Roth Match

Employer Profit Sharing -> Roth Profit Sharing



And so on, right down the line for each contribution source the participant wishes to convert. A participant can choose to transition some sources, but not others, or some portion of each source rather than the entire account. It is basically up to each participant, limited only by any constraints imposed in the plan document. It is also a good idea to check with your recordkeeper just to make sure they do not have any limitations.

It is important to note that each transfer is a "one and done" transaction. In other words, converting the current balance in the match account will not result in future matching contributions automatically being made in Roth form. A participant can elect to have future deferrals be made as Roth, but any employer contributions will be pre-tax and available for future transfers as elected by the participant.

#### What's the Catch?

There are two really important things that participants will want to keep in mind before moving forward. First is that the entire amount being converted is subject to individual income tax for the year of conversion. That includes contributions as well as investment gains. You mentioned that this participant has been with you for a few years. Depending on the size of her balance, the transition could result in a fairly hefty tax burden come next April 15<sup>th</sup>. Fortunately, because this transfer is not a distribution, there is no mandatory 20% tax withholding, and there is no 10% early withdrawal penalty even if the participant is under age 59 ½.

Second is the rule that a participant must have had a Roth account for at least five years in order take advantage of tax-free distributions. That five-year clock starts ticking on the date of conversion, so participants should factor that in to their decision if they are approaching the time when they wish to start taking withdrawals.

#### **Related Resources**

- What Are the Different Types of 401(k) Contributions?
- After-Tax vs. Roth Contributions: What's the Difference?



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