Fiscal Cliff Legislation Includes New Roth Conversion Opportunity

Client Advisories

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Many 401(k), 403(b) and 457(b) retirement plans include a provision allowing employees to select between traditional salary deferrals and contributions to Roth accounts. Contributions to traditional accounts are made on a pre-tax basis, meaning those amounts, and the earnings thereon, are not currently included in employees' income for federal income tax purposes. The contributions and earnings are taxed upon distribution from the plan, unless rolled over to another tax-deferred arrangement such as a rollover IRA. Contributions to Roth accounts are included in income currently, but distributions from Roth accounts, including earnings on those accounts, are exempt from federal income tax, provided certain rules are followed.

Now, a retirement plan that provides for both traditional and Roth accounts for employee contributions may offer plan participants the opportunity to convert the traditional account to a Roth account within the plan at any time. Previously, this option was only allowed to be offered to participants who were eligible for a distribution from the plan, such as those who had attained a certain age or terminated employment. When a traditional account converts to a Roth account, the participant must currently pay federal income tax on the amount converted.

Why was this measure part of the fiscal cliff legislation? The federal government supports the provision of employee benefits through preferential tax treatment. Traditionally, this treatment for pension benefits has been tax deferral. Roth accounts have offered a different approach: partial tax exemption. The new rule increases current budgeted revenue, since conversion of traditional to Roth accounts eliminates the tax deferral feature and generates immediate tax dollars for the government. Future revenue would presumably be reduced due to the exemption of earnings from taxable income. The Joint Committee on Taxation estimated the net effect of this provision over five years at over $4.2 billion in additional revenue.

Whether any individual would benefit financially by converting a traditional 401(k) to a Roth 401(k) depends on a number of factors, including current and future marginal tax rates for the individual and anticipated investment returns.

If you would like to discuss this aspect of a conversion in more detail, or wish to amend your plan to permit expanded conversion opportunities for your plan participants, please contact Nancy Wasch, Partner in Archer's Employee Benefits and Executive Compensation Group, at nwasch@archerlaw.com or (215) 246-3106 or Gerry Rigby, Group Chair, at grigby@archerlaw.com or (215) 246-3160.

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