Abstract: As highly compensated employee (HCE) 401(k) plan participants approach retirement, a potentially useful tax-efficient IRA rollover technique may be a valuable savings tool. This brief article reviews IRS rules about how HCEs can allocate both pretax and after-tax employee contribution 401(k) assets between standard and Roth IRAs.

IRS permits high-earner Roth IRA rollover opportunity

Are you a highly compensated employee (HCE) approaching retirement? If so, and you have a 401(k), you should consider a potentially useful tax-efficient IRA rollover technique. The IRS has specific rules about how participants such as you can allocate accumulated 401(k) plan assets based on pretax and after-tax employee contributions between standard IRAs and Roth IRAs.

High-earner dilemma

In 2017, the top pretax contribution that participants can make to a 401(k) is $18,000 ($24,000 for those 50 and older). Plans that permit after-tax contributions (several do) allow participants to contribute a total of $54,000 ($36,000 above the $18,000 pretax contribution limit). While some highly compensated supersavers may have significant accumulations of after-tax contributions in their 401(k) accounts, the tax law income caps block the highest paid HCEs from opening a Roth IRA.

However, under IRS rules, these participants can roll dollars representing their after-tax 401(k) contributions directly into a new Roth IRA when they retire or no longer work for the companies. Thus, they'll ultimately be able to withdraw the dollars representing the original after-tax contributions — and subsequent earnings on those dollars — tax-free.

An example

Participants can contribute rollover dollars to conventional and Roth IRAs on a pro-rata basis. For example, suppose a retiring participant had $1 million in his 401(k) plan account, $600,000 of which represents contributions. Suppose further that 70% of that $600,000 represents pretax contributions, and 30% is from after-tax contributions. IRS guidance clarifies that the participant can roll $700,000 (70% of the $1 million) into a conventional IRA, and $300,000 (30% of the $1 million) into a Roth IRA.

The IRS rules allow the retiree to roll over not only the after-tax contributions, but the earnings on those after-tax contributions (40% of the $300,000, or $120,000) to the Roth IRA provided that the $120,000 will be taxable for the year of the rollover.

Alternatively, the IRS rules allow the retiree to delay taxation on the earnings attributable to the after-tax contributions ($120,000) until the money is distributed by contributing that amount to a conventional IRA, and the remaining $180,000 to the Roth IRA.

Under each approach, the subsequent growth in the Roth IRA will be tax-free when withdrawn. Partial rollovers can also be made, and the same principles apply.

Golden years ahead

HCEs face some complex decisions when it comes to retirement planning. Let our firm help you make the right moves now for your golden years ahead.