

# FINANCIAL MANAGEMENT

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## **A Choice: Taxable or Tax-Free Income in Retirement?**

*Some retirement plans are allowing Roth conversions*

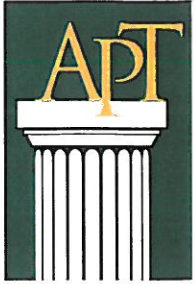
Forty years ago, the Stanford marshmallow experiment explored self-control by offering preschoolers a choice: Take a marshmallow immediately and get only one or wait to take a marshmallow and get two. Some chose the first option; others the second. Soon, participants in some 401(k), 403(b), and 457 plans may be faced with a comparably difficult choice. In its most abbreviated form the decision boils down to this: Do you want taxable or tax-free income when you retire?

Recent legislation has made it possible for plan sponsors to allow plan participants to convert their Traditional employer-sponsored retirement plan accounts into Roth accounts. Participants may either continue to make Traditional pre-tax contributions to their plans, let their assets grow tax-deferred, and receive taxable distributions during retirement or they can pay taxes today, let their assets grow tax-free, and take tax-free distributions as long as certain requirements are met.<sup>1</sup>

### **Traditional and Roth 401(k) Plan Options**

The type of employer-sponsored retirement plan account you have – Traditional or Roth – determines how the money you save in the plan may be taxed today and in the future. Typically, contributions to Traditional retirement plan accounts are made with before-tax dollars so these contributions can reduce your current taxable income. Any earnings in Traditional accounts grow tax-deferred until withdrawn, which generally is at retirement. Currently, distributions from Traditional retirement plan accounts are taxed as ordinary income. Savings in Roth retirement plan accounts, on the other hand, are made with after-tax dollars so they do not reduce taxable income today. However, any earnings in these accounts grow tax-free and qualified distributions are federally tax-free.

Roth retirement plan contributions have been around for less than a decade and were relatively slow to catch on when they were first introduced. As a result, if you started saving in a retirement plan at work more than five years ago, it's likely all or most of your contributions were made to a Traditional plan account. Since 2007, the number of employers allowing Roth contributions has grown from 11 to 50 percent, according to a 2013 study from Aon Hewitt. In 2013, about 30 percent of plans that offered Roth contribution options also allowed in-plan Roth rollovers or conversions. Another 16 percent of plan sponsors are expected to add the feature by the end of 2014.



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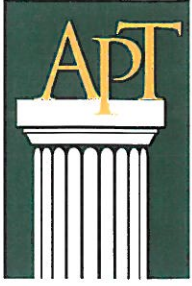
## Roth In-plan Conversions

In-plan Roth conversions are not new. Since the Small Business Jobs Act passed in 2010, plan participants who qualified to take distributions – generally meaning they had reached retirement age, were retiring, or were leaving their employer – were eligible to convert all or part of a Traditional plan account into a Roth account. That changed with the American Taxpayer Relief Act of 2012 (ATRA) which makes it possible for full or partial conversions to take place without a qualifying event, as long as the plan sponsor allows it.

## Is a Roth Conversion Right for You?

The idea of having tax-free income in retirement can be appealing, but Roth conversions are not right for everyone. Here are some things to consider when weighing the pros and cons:

- **Current and future tax brackets:** If you're young and expect your tax bracket will increase over time, a Roth may make sense, especially if your tax bracket in retirement is likely to be higher than it is now. If you expect to be in a lower tax bracket in retirement, a Roth may not be for you.
- **Higher tax bill this year:** Roth conversions require you to pay income taxes on any amounts converted in the year of the conversion. You should have non-retirement plan savings available to pay these taxes so you don't incur withdrawal penalties.
- **Required Minimum Distributions (RMDs):** If you won't need the assets in your plan account and would like to avoid RMDs after you reach age 70½, a rollover into a Roth Individual Retirement Account (IRA) may be a good choice since Roth IRAs do not require withdrawals until after the death of the owner. Roth 401(k) accounts are subject to RMDs.
- **Inheritance and estate plans:** Since RMDs are not required if you have a Roth IRA, rolling Roth plan assets into a Roth IRA may allow you to provide your heirs with tax-free income over their lifetimes, as well as years and years of potential tax-free growth.



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If you're intrigued by the idea of a Roth conversion and would like to learn more, please contact our office and/or a tax professional. This may help you determine whether an in-plan conversion makes sense for you.

Sources:

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The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which course of action may be appropriate for you, consult your financial advisor prior to making an investment decision.

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<sup>1</sup> Roth account distributions may be tax-free and penalty-free as long as you've had the account for five or more years and you are age 59½ or older, disabled, making a qualified first-time home purchase, or deceased.

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The above material was prepared by Peak Advisor Alliance.