Artemis
FINANCIAL ADVISORS

Artemis Investment Brief: No. 15

Should You Contribute After-Tax Dollars to your Retirement Plan?

By Leigh Bivings, Ph.D., CFP®

About half of company 401(k) plans allow participants to make non-deductible, after-tax contributions over and above the current pre-tax contribution limit of $18,000 per year, up to the overall cap of $54,000. In this note, we explain why a new IRS ruling is making such contributions a pretty good idea.

The ostensible value of making after-tax contributions to a 401(k) is that earnings grow tax-deferred, even though the original contribution was non-deductible. The trade-off is that once the earnings are with-drawn, they are taxed at ordinary income tax rates, not the lower long-term capital gains rates. As such, this savings strategy has rarely paid off for high-income earners because it takes a very long deferral period to make up the difference between (for example) a 40% income tax rate and a 20% capital gains rate.

In addition, withdrawals and rollovers have had to be made on a pro-rata basis, making it impossible to isolate the pre-tax money from the post-tax money. For instance, say you had a $200,000 401(k) balance that included $40,000 (20% of the total) of after-tax funds. Upon leaving your company, if you wanted to roll over half of the total to a regular IRA account and another half to a Roth IRA account, each $100,000 portion had to be treated as 80% pre-tax and 20% post-tax. As such, the $80,000 of total going to the Roth account was immediately subject to income taxes, which makes the Roth conversion strategy less attractive.

New IRS Ruling

A new IRS rule came into effect last year that eliminates this obligation. Now, when a 401(k) participant wants to roll over his or her 401(k) account to more than one IRA, the recipient can select how the pretax amount is allocated among the IRAs. Effectively, this isolates all of the pre-tax contributions and earnings to a traditional IRA, and the post-tax contributions to a Roth IRA. This makes the Roth conversion completely tax-free!

Using the same example above, the participant would ask the company's 401(k) plan administrator for two checks: one for $40,000 destined for the Roth, and one for $160,000 to a traditional IRA. The only requirements are: the two distributions must happen together; they must equal the total value of the account; and the plan administrator must be adequately notified of how the funds should be allocated across the two IRAs.

As a result of this new ruling, the hierarchy of tax-efficient savings strategies may now be:

1. Obtain the 401(k) match.

1. Max out pre-tax 401(k) and IRA contributions or Roth 401(k) and Roth IRA contributions if your current tax bracket is low (e.g., contribute the full $18,000 to your 401(k).

2. Make after-tax contributions to the 401(k) plan up to the defined contribution plan limit $54,000.

3. Contribute to a low-cost deferred annuity in which earnings are tax-deferred but the after-tax contributions can't be isolated for a subsequent Roth conversion.

Bottom Line:

There aren't many tax-efficient savings and investment strategies left for high-income earners, so making after-tax 401(k) contributions deserves consideration. Moreover, while President-elect Donald Trump wants to cut taxes on the wealthy and spend like there is no tomorrow, there will be a tomorrow and tax rates will eventually have to jump back up to pay the piper. When this happens, having some Roth money may save you a lot.

Artemis Financial Advisors
54 Chandler Street
Boston, MA 02116

617-542-2420