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Converting Your After-Tax 401(k) Dollars to a Roth IRA

Last-Minute Tax Tips

The Cost of Waiting

How much can I contribute to my IRA in 2015?

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Converting Your After-Tax 401(k) Dollars to a Roth IRA

Here's the dilemma: You have a traditional 401(k) that contains both after-tax and pre-tax dollars. You'd like to receive a distribution from the plan and convert only the after-tax dollars to a Roth IRA. By rolling over/converting only the after-tax dollars to a Roth IRA, you hope to avoid paying any income tax on the conversion.

For example, let's say your 401(k) plan distribution is $10,000, consisting of $8,000 of pre-tax dollars and $2,000 of after-tax dollars. Can you simply instruct the trustee to directly roll the $8,000 of pre-tax dollars to a traditional IRA and the remaining $2,000 of after-tax dollars to a Roth IRA?

In the past, many trustees allowed you to do just that. But in recent years the IRS had suggested that this result could not be achieved with multiple direct rollovers. Instead, according to the IRS, each rollover would have to carry with it a pro-rata amount of pre-tax and after-tax dollars. The legal basis for this position, however, was not entirely clear.

And while some experts suggested that it might be possible to achieve a tax-free Roth conversion of after-tax dollars using 60-day rollovers, the process was fairly complicated, and it required taxpayers to have sufficient funds outside the plan to make up the 20% mandatory withholding that would apply to the taxable portion of the distribution.

IRS Notice 2014-54

Thankfully, in Notice 2014-54 (and related proposed regulations), the IRS has backed away from its prior position. The Notice makes it clear that you can split a distribution from your 401(k) plan and directly roll over only the pre-tax dollars to a traditional IRA (with no current tax liability) and only the after-tax dollars to a Roth IRA (with no conversion tax). The IRS guidance, which took effect January 1, 2015, also applies to 403(b) and 457(b) plans.

When applying Notice 2014-54, it's important to understand some basic rules (also outlined in the Notice). First, you have to understand how to calculate the taxable portion of your distribution. This is easy if you receive a total distribution--the nontaxable portion is your after-tax contributions, and the taxable portion is the balance of your account. But if you're receiving less than a total distribution, you have to perform a pro-rata calculation.

This is best understood using an example. Assume your 401(k) account is $100,000, consisting of $60,000 (six tenths) of pre-tax dollars and $40,000 (four tenths) of after-tax dollars. You request a $40,000 distribution. Of this $40,000, six tenths, or $24,000, will be taxable pre-tax dollars, and four tenths, or $16,000, will be nontaxable after-tax dollars. What this means is that you can't, for example, simply request a distribution of $40,000 consisting only of your after-tax dollars. The Notice requires that you treat all distributions you receive at the same time as a single distribution when you perform this pro-rata calculation (even if you subsequently roll those distributions into separate IRAs).

Taking this example a step further, could you now direct the trustee to directly transfer the $16,000 of after-tax dollars to a Roth IRA (with no conversion tax) and send the remaining $24,000 to you in a taxable distribution? The answer is no, and this leads to a second basic rule described in the Notice: Any rollovers you make from a 401(k) plan distribution are deemed to come first from your pre-tax dollars, and then, only after these dollars are fully used up, from your after-tax dollars. If you're rolling your distribution over into several different accounts, you get to decide which retirement vehicle receives your pre-tax dollars first.

It's these new rules that allow you to accomplish your goal of rolling over only the after-tax portion of your 401(k) plan distribution into a Roth IRA. Going back to our example, these rules make it clear that you can instruct the 401(k) plan trustee to transfer only your pre-tax dollars--$24,000--to your traditional IRA, leaving the remaining $16,000--all after-tax dollars--to be rolled over to your Roth IRA in a tax-free conversion.

Last-Minute Tax Tips

It's that time of year again--tax filing season. And while many taxpayers like to get a head start on filing their returns, there are those of us who always find ourselves scrambling at the last minute to get our tax returns filed on time. Fortunately, even for us procrastinators, there is still time to take advantage of some last-minute tax tips.

If you need more time, get an extension

Failing to file your federal tax return on time could result in a failure-to-file penalty. If you don't think you'll be able to file your tax return on time, you can file for and obtain an automatic six-month extension by using IRS Form 4868. You must file for an extension by the original due date for your return. Individuals whose due date is April 15 would then have until October 15 to file their returns.

In most cases, this six-month extension is an extension to file your tax return and not an extension to pay any federal income tax that is due. You should estimate and pay any federal income tax that is due by the original due date of the return without regard to the extension, since any taxes that are not paid by the regular due date will be subject to interest and possibly penalties.

Try to lower your tax bill

While most tax-saving strategies require action prior to the end of the tax year, it's still not too late to try to lower your tax bill by making deductible contributions to a traditional IRA and/or pre-tax contributions to an existing qualified Health Savings Account (HSA). If you're eligible, you can make contributions to these tax-saving vehicles at any time before your tax return becomes due, not including extensions (for most individuals, by April 15 of the year following the year for which contributions are being made).

For tax year 2014, you may be eligible to contribute up to $5,500 to a traditional IRA as long as you're under age 70½ and have earned income. In addition, if you're age 50 or older, you may be able to make an extra "catch-up" contribution of $1,000. You can make deductible contributions to a traditional IRA if neither you nor your spouse is covered by an employer retirement plan; however, if one of you is covered by an employer plan, eligibility to deduct contributions phases out at higher modified adjusted gross income limits. For existing qualified HSAs, you can contribute up to $3,300 for individual coverage or $6,550 for family coverage.

Use your tax refund wisely

It's easy to get excited at tax time when you find out you'll be getting a refund from the IRS--especially if it's a large sum of money. But instead of purchasing that 60-inch LCD television you've had your eye on, you may want to use your tax refund in a more practical way. Consider the following options:

- Deposit your refund into a tax-savings vehicle (if you're eligible), such as a retirement or education savings plan--the IRS even allows direct deposit of refunds into certain types of accounts, such as IRAs and Coverdell education savings accounts.
- Use your refund to pay down any existing debt you may have, especially if it is in the form of credit-card balances that carry high interest rates.
- Put your refund toward increasing your cash reserve--it's a good idea to always have at least three to six months worth of living expenses available in case of an emergency.

Finally, a tax refund is essentially an interest-free loan from you to the IRS. If you find that you always end up receiving a large income tax refund, it may be time to adjust your withholding.

Beware of possible tax scams

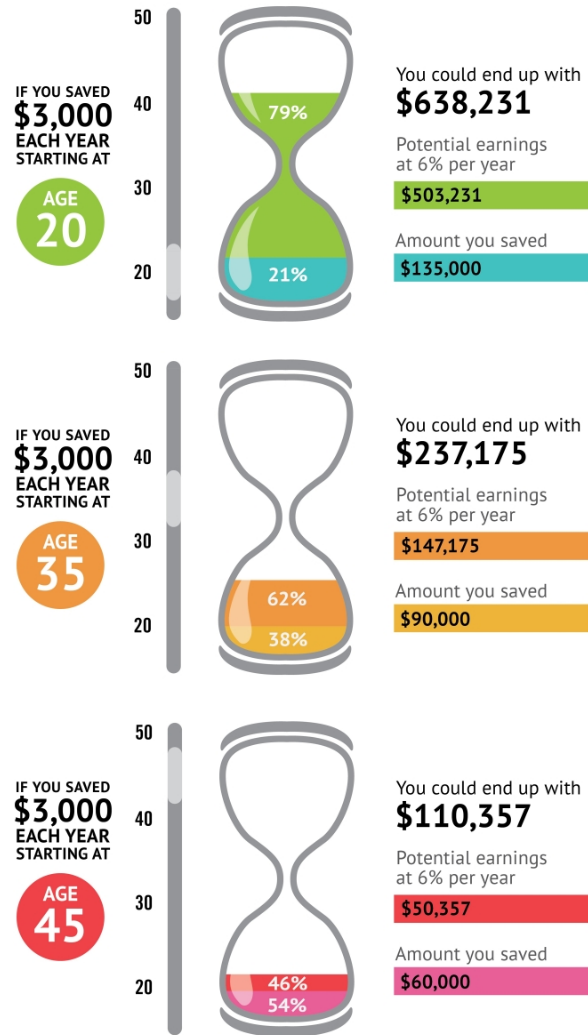
Though tax scams can occur throughout the year, they are especially prevalent during tax season. Some of the more common scams include:

- Identity thieves who use your identity to fraudulently file a tax return and claim a refund.
- Callers who claim they're from the IRS insisting that you owe money to the IRS or that you're entitled to a large refund.
- Unsolicited e-mails or fake websites, often referred to as "phishing," that pose as legitimate IRS sites to convince you to disclose personal or financial information.
- Scam artists who pose as tax preparers and promise unreasonably large or inflated refunds in order to commit refund fraud or identity theft.

The IRS will never call you about taxes owed without sending you a bill in the mail. If you think you may owe taxes, contact the IRS directly at www.irs.gov. In addition, the IRS will never initiate contact with you by e-mail to request personal or financial information. If you believe that you've been the victim of a tax scam, or would like to report a tax scammer, contact the Treasury Inspector General for Tax Administration at www.treasury.gov/tigta.

The Cost of Waiting

Starting to save early means your money has more time to go to work for you. Even if you can only afford to set aside small amounts, compounding earnings can make them really add up. It's never too late to begin, but as this illustration shows, the sooner you start, the less you may need to rely solely on your own savings to build your total nest egg.



This illustration assumes annual investments made at the end of each year through age 65 and a 6% fixed annual rate of return. The rate of return on your actual investment portfolio will be different, and will vary over time, according to actual market performance. This is particularly true for long-term investments. It is important to note that investments offering the potential for higher rates of return also involve a higher degree of risk to principal.

The examples do not take into account the impact of taxes or inflation; if they did, the amounts would have been lower. They are intended as hypothetical illustrations of mathematical principles and should not be considered financial advice.

All investing involves risks, including the possible loss of principal, and there can be no guarantee that any strategy will be successful. Past performance is no guarantee of future results.

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How much can I contribute to my IRA in 2015?

The combined amount you can contribute to your traditional and Roth IRAs remains at $5,500 for 2015, or $6,500 if you'll be 50 or older by the end of the year. You can contribute to an IRA in addition to an employer-sponsored retirement plan like a 401(k). But if you (or your spouse) participate in an employer-sponsored plan, the amount of traditional IRA contributions you can deduct may be reduced or eliminated (phased out), depending on your modified adjusted gross income (MAGI). Your ability to make annual Roth contributions may also be phased out, depending on your MAGI. These income limits (phaseout ranges) have increased for 2015:

Income phaseout range for deductibility of traditional IRA contributions in 2015	
1. Covered by an employer-sponsored plan and filing as:	
Single/Head of household	$61,000 - $71,000
Married filing jointly	$98,000 - $118,000
Married filing separately	$0 - $10,000
2. Not covered by an employer-sponsored retirement plan, but filing joint return with a spouse who is covered by a plan	$183,000 - $193,000

Income phaseout range for ability to contribute to a Roth IRA in 2015	
Single/Head of household	$116,000 - $131,000
Married filing jointly	$183,000 - $193,000
Married filing separately	$0 - $10,000

Is there a new one-rollover-per-year rule for 2015?

Yes. The Internal Revenue Code says that if you receive a distribution from an IRA, you can't make a tax-free (60-day) rollover into another IRA if you've already completed a tax-free rollover within the previous one-year (12-month) period. The long-standing position of the IRS was that this rule applied separately to each IRA someone owns. In 2014, however, the Tax Court held that regardless of how many IRAs he or she owns, a taxpayer may make only one nontaxable 60-day rollover within each 12-month period.

The IRS announced that it would follow the Tax Court's decision, but that the revised rule would not apply to any rollover involving an IRA distribution that occurred before January 1, 2015. The IRS recently issued further guidance on how the revised one-rollover-per-year limit is to be applied. Most importantly, the IRS has clarified that:

- All IRAs, including traditional, Roth, SEP, and SIMPLE IRAs, are aggregated and treated as one IRA when applying the new rule. For example, if you make a 60-day rollover from a Roth IRA to the same or another Roth IRA, you will be precluded from making a 60-day rollover from any other IRA--including traditional IRAs--within 12 months. The converse is also true--a 60-day rollover from a traditional IRA to the same or another traditional IRA will preclude you from making a 60-day rollover from one Roth IRA to another Roth IRA.
- The exclusion for 2014 distributions is not absolute. While you can generally ignore rollovers of 2014 distributions when determining whether a 2015 rollover violates the new one-rollover-per-year limit, this special transition rule will NOT apply if the 2015 rollover is from the same IRA that either made, or received, the 2014 rollover.

In general, it's best to avoid 60-day rollovers if possible. Use direct (trustee-to-trustee) transfers--as opposed to 60-day rollovers--between IRAs, as direct transfers aren't subject to the one-rollover-per-year limit. The tax consequences of making a mistake can be significant--a failed rollover will be treated as a taxable distribution (with potential early-distribution penalties if you're not yet 59½) and a potential excess contribution to the receiving IRA.

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Currency Wars?

What is a "currency war" and how does one wage it?

Forget world wars, fought with tanks, bomb and missiles. The new form of global conflict is the currency war, which is fought with increasingly vicious keystrokes. We read in the papers that this or that country is engaged in a currency war with some other set of countries. But what does that really mean? And is the U.S. currently engaged on one of these economic battlefields?

Currency wars are fought over exports and foreign trade—which affects the relative prosperity of one country compared with the people living on the other side of the border. At the heart of the "conflict" is the idea that whenever our dollar can buy more of their euros, yen or yuan (when, in other words, our currency is strong and theirs is weak), their companies are able to sell their manufactured exports at lower prices in the U.S. market and still collect the same number of euros, yen or yuan. This gives those foreign exporters a golden opportunity to increase market share and profits at the same time.

When sales and profits rise, their stock market goes up, and they can pay their workers more. Meanwhile, our companies, whose goods and services suddenly look more expensive, lose top-line sales, profits and stock market value.

Of course, when the dollar is weak, the reverse is true. These same general dynamics hold true for any two countries and their currencies, which helps explain why the Swiss central bank fought for five years to hold the value of the Swiss franc down to 1.2 francs to the euro for a number of years, and why it was so shocking when it abruptly gave up the battle. When the bank let the Swiss franc rise to its fair market level, Swiss manufacturers complained that overnight their products were suddenly 12% more expensive than they had been the day before. Many faced the choice of seeing sales diminish to zero or lose money on everything they sold in the Eurozone. Companies all over the country are cutting jobs, asking workers to work longer or requesting government subsidies.

The short-term "winners" of a currency war weaken their currency compared with others, while the "losers" end up with a strong currency that can buy more imports for less. As with anything economics, there is another side. In this case, the longer-term impacts of a devalued currency may not be desirable (inflation).

But how, exactly, do you wage a currency war? One way is to create or eliminate free currency. The U.S. Federal Reserve can create more dollars by simply keystroking more of them into bank reserve accounts. Or the U.S. Treasury could issue more bonds. Alternatively, the Fed can keep its Fed funds rate at zero, which tends to raise the amount of money that banks loan to their customers and therefore the overall money supply in circulation.

Other countries, meanwhile, can "fight back" by issuing more government debt and using the money to buy Treasuries for their government account, raising the amount of their currency on the market and decreasing the number of dollars. This is how China has managed to keep the yuan on par with the dollar. In fact the Chinese government has been so active in buying up Treasury bonds that the government gave it a direct computer link to Treasury auctions, the only country with such access. The Chinese central banking system owns an estimated $1.25 trillion (face amount) of Treasuries, in an intervention program that has helped make Chinese exports inexpensive in the U.S. Japan, the second-most-active currency warrior, now holds $1.24 trillion worth of Treasuries.

Meanwhile, the Federal Reserve's various QE programs, which had one arm of the government buying the bonds of another arm of the government, have been described as frontal attacks in the currency wars.

So whenever you read that a central bank has lowered its reserve rate or is buying the bonds of its own country—as the European Central Bank did recently in an effort to revive the euro economies—it is on the attack in the global currency battlefield. Whenever you read about a strong dollar, you know that the U.S. is losing the currency wars. The weaker the dollar, the more competitive U.S. exports will be on the world markets, and the more inclined people in the U.S. will be to purchase products made in America.

But how, exactly, do these wars affect you? When the dollar is strong—as it is now, relatively speaking, against the euro—it means that your trip to Paris or Stockholm will be cheaper, and so will the meals and cab rides you pay for over there. So if you're planning to travel abroad, it isn't so terrible if the U.S. is temporarily losing the currency battles.

In addition, when the dollar is strong, your cost of living tends to be lower, because the cost of foreign products—of which the U.S. bought an estimated $2.6 trillion worth last year—are cheaper. And of course if you buy American, it doesn't really matter to you who happens to be winning this round of the currency wars. Unlike the bloodier kind of war, the impact of winning or losing on the currency battlefield aren't threatening your personal—or financial—survival.

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Will Social Security Be There When I Retire?

Social Security's future solvency has become one of the most commonly-discussed issues in retirement planning—and for good reason. Gallup polls show that an estimated 57% of retirees rely on Social Security as a major source of retirement income—a number that has held steady since the early 2000s. But when Generation X and Y individuals plan for their future retirement, they'll often ask their advisor to assume that Social Security won't be there for them 20 or 30 years down the road.

However, if you look closely at the numbers, you see a very different story. Up until 2011, the Social Security system actually collected more revenues from workers' FICA payments than it paid out—and that has been generally true since the 1940s. Most of the Social Security benefits that people receive today are simply a transfer; that is, the money is collected from worker paychecks (and, of course, employer matches), spends a few days at the U.S. Treasury and then is paid out to recipients. The surplus has been used to pay government operating expenses, and for seven decades, the government issued "special issue federal securities" (essentially fancy IOUs that pay interest) to the Social Security trust fund.

In 2011, the program crossed that threshold where benefit payments slightly exceeded the amount collected. Why? Because the number of beneficiaries, compared to the number of workers, has steadily increased. In 1955, there were more than eight workers paying into Social Security for every beneficiary. Today, that number is closer to three workers for every beneficiary, and by 2031, if current estimates are correct, that ratio will fall to just over two workers supporting every retired beneficiary.

When Social Security Administration actuaries crunch the numbers, they have to take into account the shifting demographics, and then make estimates of fertility and immigration rates, longevity, labor force participation rates, the growth of real wages and growth of the economy every year between now and 2078. After adding in the value of the government IOUs, they estimate that if nothing is done to fix the system, the trust fund IOUs will run out in the year 2033. At that time, only the FICA money collected from workers would be available to pay Social Security beneficiaries. In real terms, that means the beneficiaries would, in 2034, see their payments drop to 77% of what they were promised.

In other words, the money being transferred from current workers to beneficiaries through the FICA payroll program, assuming no course corrections between now and 2033, will be enough to pay retirees 77% of the benefits they were otherwise expecting.

The government actuaries say that if nothing is done to fix the problem over the next 63 years, this percentage will gradually decline to 72% by the year 2078.

So the first takeaway from these analyses is that today's workers are looking at a worst-case scenario of only receiving about 75% of the benefits that they would otherwise have expected to receive. This is far different from the zero figure that they're asking their advisors to use in retirement projections.

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How likely is it that there will be no course corrections? There are two possible ways that this 75% figure could go up. One lies in the assumptions themselves. The Social Security Administration actuaries have tended to err on the side of conservatism, presumably because they would rather be pleasantly surprised than discover that they were too optimistic. But what if the future doesn't look as gloomy as their assumptions make it out to be?

To take just one of the variables, the actuaries are projecting that labor force participation rates for men will fall from 75.5% of the population in 1997 to 74% by 2075, while the growth in female workers will stop their long climb and peter out around 60%. If male labor force participation rates don't fall, and if female rates continue to rise, some of the funding gap will be eliminated.

Similarly, the projections assume the U.S. economy's productivity gains (which drive wage increases) will grow 1.3% a year, well below long-term U.S. averages and certainly below the assumptions of economists who believe that biotech and information age revolutions will spur unprecedented growth. If real wages were to grow at something closer to the post-Great Recession rate of 2% a year, then more than half of the funding gap would be eliminated. If the current slump in immigration (due to tighter immigration policies) is reversed, and the economy grows faster than the anemic 2% rates the Social Security Administration is projecting (compared to 2.5% recently), then the "bankrupt" system begins to look surprisingly solvent.

A second possibility is that Congress will tweak the numbers and bring Social Security's long-term finances back in balance, as it has done 21 times since the program originated in 1937. The financial press often cites the fact that the total future Social Security funding shortfall amounts to $13.6 trillion, but they seldom add that this represents just 3.5% of future taxable payrolls through 2081. Small tweaks—like extending the age to collect full retirement benefits from 67 to 68, raising the FICA tax rate by 3.5 percentage points or making the current 12.4% rate (employee plus employer match) apply to all taxable income rather than the $118,500 current limit—would restore solvency far enough into the future that today's workers would be comfortable adding back 100% of their anticipated benefits into their retirement projections.

How likely is it that Congress will take these measures, in light of recent partisan budget battles? It's helpful to remember that older Americans tend to vote with more consistency than younger citizens. The more you've paid into the system, the more you expect to at least get back the money you were promised.

The bottom line here is that if you're skeptical about Social Security's future solvency, then you should pencil in 75% of the benefits you would otherwise expect—rather than $0. Meanwhile, as you approach the age when you're eligible for benefits, watch for signs that immigration restrictions are loosening, the economy is growing faster than the SSA actuaries' gloomy projections, that more people are working during traditional retirement years or yet another round of tweaks from our elected representatives.