After-Tax Contributions Make a Comeback

Opportunities with an In-Plan Rollover

The updated Internal Revenue Service's (IRS) guidance concerning in-plan Roth conversions clarified how to transfer pre-tax account balances to an after-tax Roth account inside a retirement plan and affirmed that essentially all vested accounts are eligible for this conversion. Coupled with a decades-old provision that allows participants to make after-tax employee contributions in addition to their salary deferral savings, this development presents a unique planning opportunity. The $2 trillion legislative infrastructure package known as the Build Back Better bill took aim at Roth conversions, including those occurring inside of an employer-sponsored retirement plan; with the prospects of this legislation waning, at least as of the time of this writing Roth conversions get to live another day.

After-Tax Contribution 1.0

After-tax employee contributions, also known as voluntary after-tax employee contributions, have been in existence for a long time; not to be confused with Roth 401(k) deferrals, which came into the picture in 2006. Historically, after-tax contributions enabled participants to direct extra funds into their retirement accounts, in addition to the traditional pre-tax 401(k) salary deferral amounts. While counting toward the annual maximum contribution, also known as (the annual additions limit), these non-deductible contributions didn't reduce the annual salary deferral limit; still, they grew tax-deferred and were only taxed on earnings when withdrawn.

Imagine this scenario: Bob, age 45, already takes full advantage of his 401(k) plan's salary deferral limit by saving
$20,500 per year in his company's retirement plan; his employer makes a matching contribution of $3,000. In addition to salary deferrals, the plan allows participants to make after-tax contributions from their pay. In 2022, the IRS' annual defined contribution plan deposit limit is the lesser of $61,000 or 100 percent of compensation. Assuming sufficient compensation, Bob can make an after-tax contribution of up to $37,500 into his account: $61,000 reduced by the $20,500 deferral and the $3,000 employer match. This contribution is made with after-tax dollars, and earnings will be tax-deferred until withdrawn. That is how the after-tax contribution 1.0 works. Now with in-plan conversions, Bob can take this approach to a whole new level.

The Opportunity

With the use of internal Roth conversion rules, a participant can make a non-Roth after-tax contribution and immediately convert that balance to Roth inside the plan. The conversion will allow the earnings to accumulate on a tax-free basis and be distributed tax-free, provided the distribution is qualified (taken after the latter of attainment of age 59½ or five years from the year of conversion).

Using the earlier example, Bob can immediately convert his after-tax deposit to Roth inside of his plan. This transaction will be penalty and tax-free.

Who Can Benefit

There are three distinct client profiles that may benefit from this opportunity:

1. Those who wish to increase their tax-free retirement assets for tax diversification purposes or to catch up on savings.
2. Those whose low plan compensation creates hindrances in reaching the annual maximum in a 401(k) plan via employer-made pre-tax contributions.
3. Those who can't reach the annual 401(k) plan maximum due to deduction limits applicable to some 401(k) profit-sharing and defined benefit/cash balance plans combinations.

Let's see how it works using the following case studies:

Client Profile 1 – Dana's Tax-Free Growth

Dana is a self-employed consultant and accumulated a substantial 401(k) plan balance over the years. Following her advisor's recommendation to diversify the tax treatment of plan distributions in retirement Dana adds the after-tax contribution, Roth 401(k) and Roth conversion features to her retirement plan, and structures her funding as follows:

- $20,500 Roth 401(k) deferral
- $22,000 profit-sharing contribution
- $18,500 after-tax employee contribution converted to Roth (if desired, she can eliminate the profit- sharing contribution and instead make a $40,500 after-tax contribution)

By making an after-tax employee contribution and immediately converting it to Roth inside the plan, Dana is able to provide a substantial boost to her tax-free account balance and overcome the Roth 401(k) contribution limit.

High-income earning individuals who participate in their employer-sponsored plans may also be able to take advantage of this opportunity, provided the plan offers after-tax contribution and in-plan conversion features. That said, if an in-plan conversion is not an option, they may still consider taking advantage of after-tax contributions and determine at the time of the eventual distribution whether they wish to convert the associated earnings to Roth or send the after-tax balances to Roth directing the tax-deferred earnings to a rollover IRA. This is another opportunity clarified by the IRS in Notice 2014-54 (click here for an overview).

Client Profile 2 – Mark Breaks through the Compensation Limit

Mark's S-corporation establishes a 401(k) plan. As a shareholder employee, Mark splits his compensation between W-2 wages ($100,000) and a shareholder distribution reported on

Schedule K-1 ($125,000). Since in S-corporations only W-2 wages are counted as eligible plan compensation, Mark's plan funding is limited to $45,500 ($20,500 salary deferral contribution withheld from the W-2 wages + $25,000 of company-paid profit-sharing contribution).

By making an after-tax contribution of $15,500 (and converting it to Roth), Mark is able to reach the $61,000 annual contribution maximum while establishing a tax-free source of retirement distributions:

- $20,500 pre-tax 401(k) deferral
- $25,000 profit-sharing contribution (25% of Mark's W-2)
- $15,500 after-tax employee contribution converted to Roth within the plan

Client Profile 3 – Barbara Maximizes Benefit from Combination Plan Design

Barbara is a self-employed consultant. Her company established an individual 401(k) plan in combination with an owner-only cash balance plan. Because of the special deduction rules applicable to certain plan combinations, Barbara's profit-sharing funding is reduced to 6 percent of her compensation.

By using the after-tax employee contribution feature, Barbara overcomes the combined plan limit because her after-tax employee contributions do not count against the 6 percent annual deduction limit for employer profit-sharing contributions:

- Cash balance plan: $100,000
- Individual 401(k): $67,500
  - $27,000 pre-tax 401(k) deferral and catch-up
  - $12,000 profit sharing contribution (6% of Barbara's pay)
  - $28,500 after-tax employee contribution converted to Roth within the plan

Some Things to Consider

In order to support this approach, certain plan design and operational requirements must be followed:

- A plan document must allow for after-tax contributions, Roth contributions and in-plan Roth conversions;
- After-tax contributions and earnings need to be tracked separately from other account balances;
- Each Roth conversion amount and associated earnings also need to be tracked separately from other account balances, including Roth 401(k) and other conversions; and
- A plan document should specify a procedure for making after-tax employee contributions.

When it comes to discrimination testing required for qualified plans that cover non-highly compensated employees, after-tax contributions are tested together with employer match. The safe harbor contribution or match provisions used by many 401(k) plans do not alleviate this test for matching contributions. For this reason, this method works best in owner-only plans or plans that have no non-highly compensation participants (both situations are exempted from this test); nonetheless, plans with substantial non-owner participation, automatic enrollment and/or generous match may also be able to take advantage of this strategy.

A Word on Tax Consequences

When an after-tax employee contribution balance is converted to a Roth via an in-plan conversion, the amount of the after-tax contribution is converted tax-free; any appreciation between the deposit and conversion time is includible in income. If the conversion is implemented shortly after the contribution, e.g., the following day, the tax consequences can be minimized if not avoided altogether.

For those making conversions prior to attainment of age 59½, there is a waiver of the 10 percent penalty for in- plan Roth conversions. In-plan Roth conversions cannot be undone.

For converted assets to be distributed free of tax, they must be taken upon attainment of age 59½ and only after five years following conversion. *The five-year period for distribution purposes* starts in the year when the first Roth dollar is deposited into a participant's account; it can be a Roth 401(k) contribution or conversion. It does not restart with each subsequent contribution and/or conversion. This is often referred to as *a five-year clock for tax-free distribution of earnings.*

Finally, there is another important five-year clock, which starts with every conversion called the *five-year period for recapture tax purposes*. If a distribution is not qualified, then it may be subject to a recapture tax determined separately with respect to every conversion. This period is tracked independently from the five-year clock for qualified distributions.

Conclusion

The after-tax contribution coupled with an expanded in-plan Roth conversion may open new possibilities for planning with Roth balances. Since Roth dollars appreciate tax-free, and there's no tax for qualified distributions, individuals may be in a better position to manage their distributions and marginal tax rates in retirement.

Retirement Plan Solutions consultants are ready to help. Please call 844.881.PLAN, email retirementplans@cetera.com or start a conversation here.