Tax Efficient 401K Planning

Andrea Solana of MASECO Private Wealth looks at two planning opportunities that may sit within your US 401(k) retirement plan

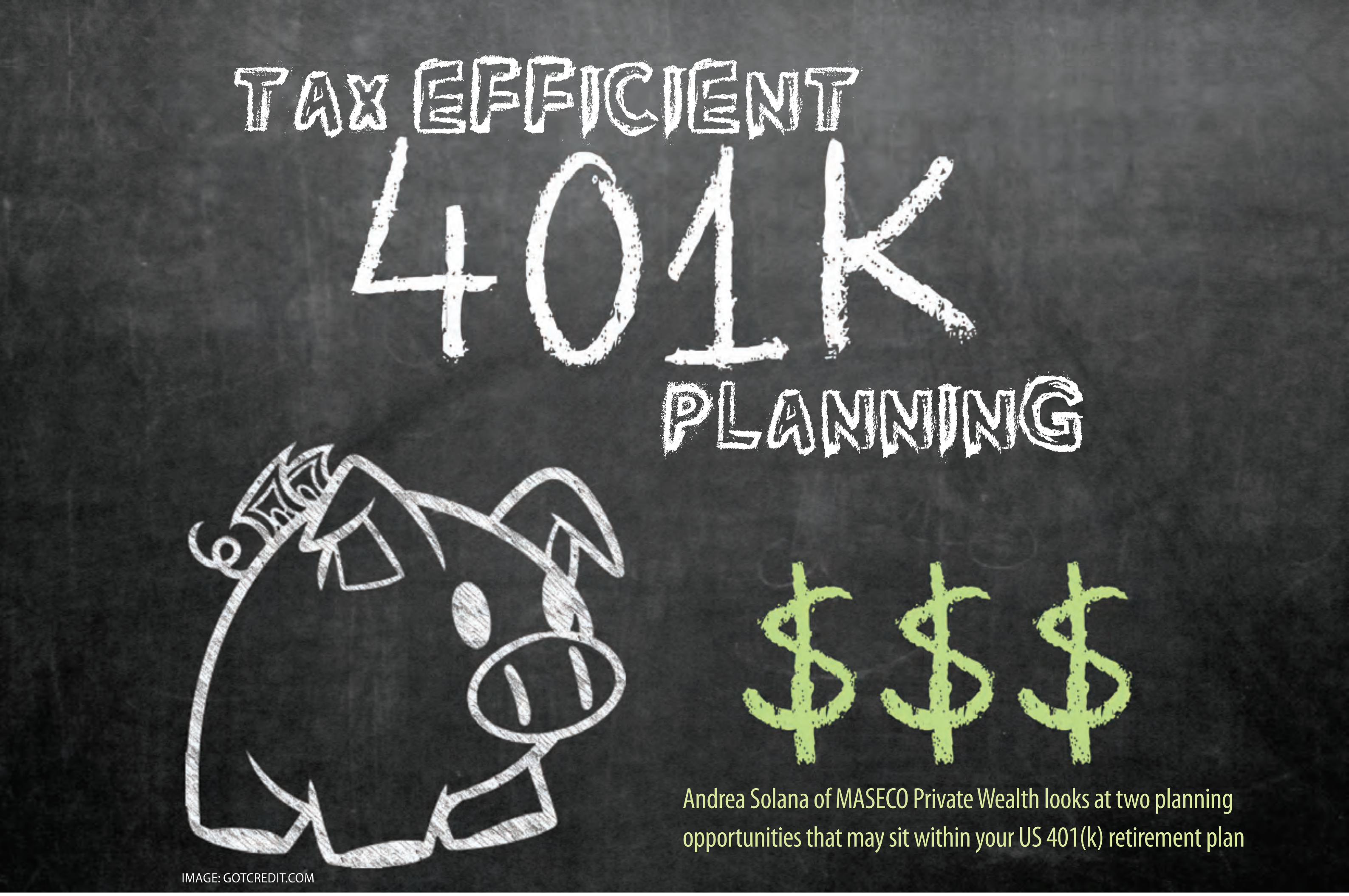

IMAGE: GOTCREDIT.COM

There is much focus around the years spent saving for retirement and the ways to accumulate assets in a tax-efficient manner. However, there tends to be less focus around how to distribute retirement assets efficiently. There are the usual rules of thumb: draw down taxable assets first, then tax deferred, then tax exempt. But, there can sometimes also be unique planning opportunities that exist for individuals with US 401(k) retirement plans to help facilitate drawdown. One opportunity is the result of an IRS clarification about the distribution treatment of 401(k) assets and another appears when holding company stock within a 401(k) plan.

Back in 2014, the IRS issued a Notice indicating that it will allow plan participants who have after-tax contribution money in their 401(k) accounts to convert this money to a Roth IRA upon separation of service from their employer, without being subject to the pro-rata tax rules that normally apply to conversions that occur from Traditional IRAs to Roth IRAs. The conversion must be made at the same time as any direct rollover of other 401(k) money (i.e. a total distribution rollover as opposed to any partial distributions). In essence, off the back of this Notice, employees can more easily roll over after-tax contributions into a Roth IRA when they retire or leave their company.

Why is this potentially so valuable? Individuals in this position have the ability to move assets directly into a Roth IRA without creating a current tax year burden and at the same time secure a bucket of money that would be available to grow tax exempt for years to come. Not only can individuals benefit from the roll up of tax exempt growth, Roth IRAs are also not subject to the Required Minimum Distribution rules as Traditional IRAs and 401(k)s are. This can provide even greater benefits for those people who have a legacy goal of passing the assets on to heirs.

The IRS clarification and the ability to segment the taxable nature and sourcing of the 401(k) assets may then also provide a valuable planning opportunity to Americans who have ever contributed to a US 401(k) whilst living and working abroad. When the opportunity arises to make contributions to a US 401(k) whilst living and working abroad, the employee contributions (and the contributions of the employer) made during the time related to overseas service would be considered foreign source for US tax purposes. Having foreign source dollars within a 401(k) may prove valuable for anyone who has excess foreign tax credits available for use on their US tax returns. At distribution, if any portion of the distribution is considered foreign source then available foreign tax credits may be used to offset associated US tax.

This means that it may be possible for some people to move the portion of the 401(k) account that represents foreign sourced dollars directly into a Roth IRA with the remaining assets moved to a Traditional IRA thereby preserving the tax deferral until distribution. Being able to bypass the Traditional IRA effectively prevents the pro-rata rule from applying thus potentially maximising the amount of money able to be converted to the Roth while minimising the amount of associated tax that would apply.

In addition to having pre-tax, after-tax, or potentially foreign sourced contributions sitting within your 401(k) plan, it is not uncommon for individuals to hold a position in company stock within their 401(k) plans. These shares are often held alongside broader fund investments usually until an individual either leaves employment with the company or retires.

Typical distributions from your 401(k) plan will be taxed at income tax rates based on your total taxable income in the year of withdrawal. However, when you hold company stock within your pension plan, the appreciation within the shares are known as net unrealised appreciation (NUA) and, if dealt with properly, can attract more favourable tax treatment at distribution.

NUA can be defined as the gain held within a company stock position. In other words, it is the difference between the current fair market value of the position and the original purchase price. At distribution, the company shares can be rolled into an IRA or can be transferred into a taxable account. In the instance that the shares are transferred into a taxable account, income tax treatment will be limited to the portion of the position that represents the original purchase price of the shares, or to the cost basis. Then, when the shares are subsequently sold, the NUA will be taxed at long-term capital gains rates as opposed to income tax rates which is generally more favourable.

Some of the broader factors that help determine the overall impact of trying to take advantage of NUA treatment have to do with the relative proportion of gain in the position versus cost basis and the differential between your income tax rates and the more preferential capital gains tax. Generally, the larger the unrealised gain within the position and the higher your overall income tax rates are, the more beneficial the NUA treatment will be.

It is important to note that any opportunity is highly dependent on individual circumstances and ensuring that you meet all of the criteria required to take advantage of any special treatment.

Any individual considering the appropriate distribution strategy should seek tax advice from a qualified tax professional to ensure that all necessary steps are taken and not mistakenly overlooked. ★

As an American living in the UK, almost nothing related to your financial affairs is easy. The consequences of seemingly simple decisions – such as how to pay for a new home or purchase a mutual fund - may create unnecessary tax charges and complexities. There are a number of key milestones that occur, from the time you arrive in the UK to the time you potentially approach and eventually reach retirement. Many of these changes will impact the appropriate wealth management strategies for American expats. Understanding how rules will change for you over time will allow you to plan ahead and make prudent financial decisions.

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