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Save money with recent IRA and 401(k) changes

Two developments are good for savers, one isn't

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You might be able to save money with two out of the three recent IRA and 401(k) changes outlined here.

Change in rollover rule

The IRS ruled late last year that after-tax contributions to 401(k)s can be rolled over to Roth IRAs. If you had enough foresight—and fortune—to maximize your pretax savings in a traditional 401(k) and invest after-tax money in a 401(k), the change could mean tax savings for you.

“This amounts to a tax-free Roth conversion,” says Kimberly Foss, founder and president of Empyrion Wealth Management in Roseville, Calif.

The development affects employees with both pretax and after-tax 401(k) investments whose high incomes made them ineligible for a Roth IRA and whose employers didn’t offer a Roth 401(k). When those folks exited their jobs, they faced a tax dilemma. If they rolled over investments into a Roth IRA, they would have to pay income tax on the tax-deferred portion of the 401(k). Conversely, if they rolled over investments into a traditional IRA, upon taking retirement distributions they would face taxes on money earned by their after-tax contributions. Advisers say maneuvers to avoid taxes while following IRS rules were complex.

The IRS has clarified its rules, so it’s easier for your rolled-over investments to retain their character. You can move your pretax 401(k) investments and earnings into a traditional IRA, where they will continue to grow tax-deferred. You can direct your after-tax 401(k) investments into a Roth IRA, where they avoid federal tax. To take advantage of that, you’ll need to roll over everything at once.

New ‘myRA’ debuts

In late December the Treasury Department unveiled the “myRA,” a new type of Roth IRA investment for those without access to, or ineligible for, employer-sponsored retirement accounts. Individuals now can make after-tax contributions to myRAs via regular payroll deduction—and see their money grow. As with Roth IRAs, the maximum annual contribution is $5,500 ($6,500 for those 50 and older), and income limits apply. MyRAs are portable from one job to another. The contribution principal can be withdrawn at any time with no tax penalty.

What’s different? Contributions are invested in just one vehicle: a U.S. Treasury retirement savings bond that won’t decline in value and pays the same floating interest rate offered in the retirement savings plan of federal workers. Once your total myRA investment reaches $15,000, however, you must roll it over into a regular Roth IRA. Find out more here.

Our **tax guide shows you how to save more on your taxes.**

Inherited IRAs aren’t protected

Though the Treasury and its agency, the IRS, were being magnanimous, the U.S. Supreme Court was getting stingy. In 2014 the court ruled that IRAs inherited by non-spouses aren’t retirement accounts at all.

For your beneficiaries, that means the inherited IRA is no longer protected from creditors in federal bankruptcy cases. (It still may be protected under some state laws.) If that protection is important to you and your family, you can solve the problem by naming an irrevocable trust, rather than a person, as the beneficiary of your IRA, Foss says.

You must set up a trust carefully to preserve a major advantage of an inherited IRA: a beneficiary’s ability to take minimum required distributions throughout his or her lifetime. “You can be 20 years old, ‘stretch’ those distributions over your lifetime, and keep the tax deferral working for you,” notes Bob Phillips, managing principal of Spectrum Management Group, an investment advisory firm in Indianapolis. If the trust isn’t structured properly, beneficiaries have to take out all funds—and pay income taxes on them—within five years of the original owner’s death, Phillips says.

Foss notes that the Supreme Court ruling doesn’t mention IRAs inherited by spouses. But that doesn’t mean that their status as true IRAs won’t be challenged one day. Both Democrats and Republicans in Congress have proposed eliminating the “stretch” benefit of inherited IRAs.

Given the Supreme Court ruling, trusts may be used more now when asset protection is a concern. But there’s a trade-off. Trusts have a top tax bracket of 39.6 percent that begins at only $12,301 of taxable income in 2015. That’s all the more reason, Foss notes, to seek advice from an estate-planning or tax professional.

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