Connect with us:

UNDERSTANDING ROTH CONVERSIONS

For Microsoft Employees

2021 VERSION

Financial Knowledge
408.414.5050
info@financialknowledge.com

About Financial Knowledge Network

Financial Knowledge Network (FKN), founded in 1989, is a nationwide provider of on-site and web-based employee financial education courses. FKN continually reviews and updates our material to stay current during changing laws and markets. Participants will gain the information, knowledge, and skills to make educated financial decisions.

Workbooks and Course Content

The information contained in this workbook and presented during the course is for educational purposes only. FKN does not recommend any financial products nor render financial/legal advice. Students should seek guidance from a tax advisor, attorney, or other financial professionals for counsel on their specific issues.

The material contained herein is believed to be accurate at the time of printing, but is subject to change. All information provided is of a general nature and is not intended to address the circumstances of any particular individual or entity. Any examples included herein are for illustrative purposes only; *no implications should be inferred*.

Instructors

Our instructors have a minimum of 10-15 years of experience in the financial services industry. Their backgrounds include previous associations with banks, brokerage houses, mortgage lending, insurance, and financial planning firms. Many of the instructors have previous teaching experience as adjunct faculty members with institutions of higher education and community colleges.

In addition to a college degree, many of the instructors also maintain a CFP® (Certified Financial Planner) credential or are currently enrolled in the CFP® Professional Education Program. Our certified instructors are required to meet annual continuing education requirements in the financial planning field.

Financial Knowledge

Financial Knowledge Network, LLC
6980 Santa Teresa Blvd Ste 203
San Jose, CA 95119-1346
www.financialknowledge.com

Authorized IACET Provider

Financial Knowledge has received authorization by the International Association for Continuing Education and Training to award CEU credit for its courses. Individuals may earn CEU credits for attending Financial Knowledge courses. Financial Knowledge provides over 75 conflict-free financial education classes to the workplace.

IACET is an internationally-recognized organization with standards and authorization for continuing education. Financial Knowledge courses are in compliance with IACET's high quality standards in the areas of learning environment, learning outcomes, instruction, course content, assessment, and support services.

In order to obtain CEU credits for attending this Financial Knowledge course, we need to receive confirmation that you've attended. This can be in the form of your printed name (first and last), email address, and your handwritten signature for live classes and through the electronic report from the online meeting center used for webcast classes. Please note your full name and email is required upon login for webcast classes to give you proper credit for attending. If you have any questions about this process, please call 408-414-5050 or email info@financialknowledge.com.

Privacy Policy Information

Financial Knowledge respects your privacy and recognizes the need to protect your personal information. We do not sell any financial products or personal financial advisory services. In addition, we do not request or collect any personal financial information from visitors to our site. Financial Knowledge's mission is to provide conflict-free financial education courses to students based on identified needs and which satisfy the ANSI/IACET standard to award ANSI/IACET CEU's.

Your personal information is used only within Financial Knowledge for maintaining a permanent student record. This student record shows the classes you attended, online follow up assessments that were successfully completed, the number of CEU's awarded (based upon the total contact hours), as well as your permission to send you emails about upcoming Financial Knowledge classes. If you no longer wish to receive emails about future Financial Knowledge classes, simply select the notifications preference box under Edit My Student Profile under My Account.

Your permanent student record is accessible only to you or authorized individuals at your employer. Other than authorized individuals at your employer, your permanent student record may be released only with your permission and notification.

Course Description

Participants who attend this course will learn about how conversions can help them increase their Roth savings.

Audience

Recommended for those who want to super charge their savings and increase their assets held within Roth accounts.

Learning Outcomes

- Discuss how after-tax, non-Roth contributions can be used to increase retirement savings
- Review the tax implications of making conversions of different types of funds
- Evaluate the feasibility of in-plan conversions
- Compare in-plan with out-of-plan conversions
- Compare 401(k) account options in the event that you leave Microsoft

Table of Contents

Introduction

There are 3 main ways in which employees can contribute to the Microsoft 401(k): traditional, Roth, and after-tax (non-Roth). Employees may also have pre-tax company match money in their 401(k) as well as rollover funds from a previous employer's 401(k). Effective October 9, 2020, all non-Roth funds many be converted into Roth funds within the 401(k) plan and enjoy the benefits of future tax free qualified Roth distributions.

Most people, however, choose to exercise the in plan conversion feature only for their after-tax, non-Roth contributions, due to tax considerations which will be discussed shortly.

After-Tax Contributions

For employees who have contributed the maximum of $19,500 in 2021 to their 401(k) plan ($26,000 for those age 50+) and would like to save even more money in their retirement plan, the after-tax (non-Roth) option allows for additional contributions. This is a way to super charge your retirement savings.[1]

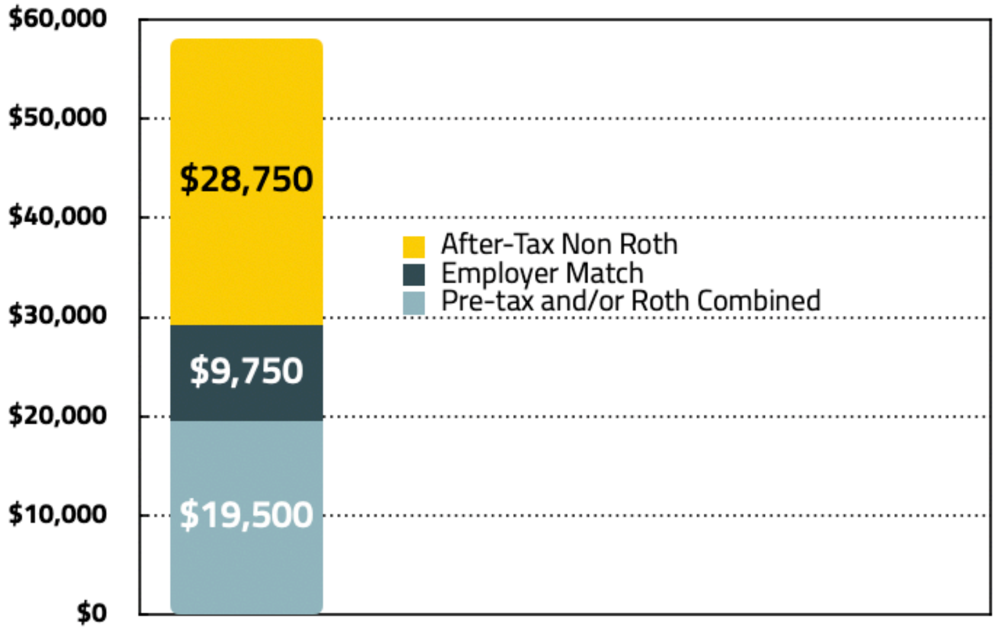
After-tax contributions (like Roth contributions) are made after taxes have been calculated on the income but are not eligible for the Microsoft match. Withdrawal of contributions is tax free since the funds have already been taxed. Earnings, however, grow tax deferred and are taxed as ordinary income upon withdrawal. Taxation of earnings can be avoided by converting after-tax 401(k) contributions to Roth contributions by completing in-plan conversions. This gives employees the ability to save more money, and benefit from the tax free earnings of a Roth contribution.

If an employee saves for retirement in a regular taxable account, they would need to pay taxes every year on any income or capital gains on their investment. If funds are in a Roth account, earnings grow tax free and all distributions will be tax free under qualified circumstances.

Contribution Limits

After-tax contributions are limited to 65% of compensation or no more than $28,750 in 2021 for Microsoft employees. This is due to the IRS specified $58,000 annual limit in 2021 for all contributions to 401(k) plans. If you are age 50 or older, the IRS limit is $64,500 in 2021. The total of all pre-tax, Roth, and after-tax contributions, plus the Microsoft match, cannot exceed those annual limits.

[1] If you have access to a Health Savings Account, consider making the maximum contribution to that before making after-tax (non Roth) contributions since HSAs have even more tax benefits and money can be accumulated for use in retirement. If you are eligible to contribute to a Roth IRA, also consider making a contribution directly to that account first.



Example

Marisol, age 32, makes $135,000 annually and is maxing out her Microsoft 401(k) plan contribution. She would like to contribute more on an after-tax basis. She also anticipates getting the maximum match of $9,750 for the year.

Here's how she would calculate the amount she can contribute on an after-tax basis:

	$58,000	IRS limit
-	$19,500	Payroll deduction on a Roth or traditional basis
-	$9,750	Microsoft Match
	$28,750	Maximum After-tax, non-Roth contribution

As long as the $28,750 does not exceed 65% of her compensation ($87,750), Marisol can contribute up to $28,750 to the 401(k) on an after-tax basis.

In the next section, we will look at how the in-plan conversion can greatly increase the amount you can save on a Roth basis for retirement with little tax liability.

In-Plan Conversions

What is it?

In-Plan conversions give employees the opportunity to convert non-Roth funds to Roth contributions. Taxes may be owed upon conversion, but future qualified distributions will be tax-free. Only vested assets are eligible to be converted. The conversion is in-plan so converted funds stay within the 401(k) plan. This is not a conversion/rollover into an IRA (individual retirement account).

Eligible Assets

Assets that are eligible for conversion include:

1. Assets rolled over from a former employer
2. Employer match from Microsoft
3. After-tax deferrals and earnings
4. Pre tax deferrals and earnings

Outstanding balances on plan loans are not eligible for conversions.

In-plan conversions do not trigger any early withdrawal penalties nor are taxes withheld. Employees may elect to do conversions as well as their surviving spouse beneficiary in the case of employee death.

You may convert some or all of your non Roth funds to Roth but be sure to specify which monies you are converting and how much.

Getting Started

You can request a Roth in-plan conversion at any times with no fees. There is no limit to the number of conversions you can do per year. You must call Fidelity at 1-888-810-MFST (6738) to initiate a conversion of funds that are not already being converted automatically. You can also set up automatic daily conversions of new after-tax assets as long as you are contributing at least 1% to your after-tax account.

To set up an automatic Roth in-plan conversion:

1. Go to Fidelity NetBenefits®
2. Go to Quick Links, then select **Contribution Amount**
3. On the Contributions page under Manage Your Contribution Amount, click on **Contribution Amount**.
4. Make your After-tax (non-Roth) contribution election
5. Choose Convert My After-Tax Contributions

Note: *If you are not currently making an after-tax contribution of at least one percent, no drop-down box will display.*

6. Click **Change Contribution Amount**.

Conversion of After-Tax Funds

Converting after-tax, non Roth funds to Roth is a tax efficient way to utilize in-plan conversions. Since the deferrals are already after tax monies, taxes will be paid only on any earnings the after-tax funds accumulate before the conversion takes place. Hence it is best to convert the after-tax funds to Roth sooner rather than later, before significant earnings have accrued. You must convert any associated earnings with the contribution - you can't elect to convert only the after-tax contribution without its taxable earnings.

Since the maximum savings limit is $58,000 for 2021 (Less employee Traditional/Roth 401k contribution limit of $19,500 (or $26,000 if age 50 or older) and company match), participants can accumulate more Roth funds in their 401(k) accounts beyond the $19,500 limit with little tax liability. This is also known as the **Mega Back Door Roth** since it's a way to funnel significantly more money into a Roth 401(k) but in a roundabout way.

Fidelity will provide a 1099-R to the employee to account for taxable earnings that was converted.

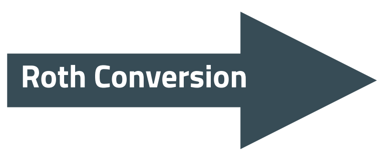
Example

May decides to convert $5,000 in after-tax funds that has $20 in earnings. The $5,000 will not be taxable but the $20 in earnings will be added to her income for 2021 for tax reporting.

Summary

Below is a simplified version of the tax consequences of in-plan Roth conversions:

After-Tax Contributions



Taxed on:

- Associated Earnings

Important: If you have after-tax funds and earnings already accumulated in the account that have not been converted, and you elect to automatically convert future after-tax contributions, you may incur a tax liability on the pro-rata portion of your account total that includes earnings.

Please consult with a qualified tax professional before initiating a conversion.

Conversion of Pre-Tax Funds

Employees may also convert pre-tax monies to Roth within the plan but please note that those funds will be fully taxable as income in the year of conversion. Taxes will not be withheld and employees must pay for the taxes due with outside money. Employees may want to consider making estimated tax payments to avoid possible interest and underpayment penalties.

Example

Juan decides to convert $10,000 in employer match funds to Roth. The $10,000 will be added to his gross income for reporting purposes and he will need to pay taxes on the $10,000 on the federal level and state level (if applicable). If his federal marginal rate is 32%, he will need to pay $3,200 in federal taxes on the conversion. Juan may want to wait until he is in a lower tax bracket to initiate a conversion.

For more information about Roth in-plan conversions and the tax consequences, please call Fidelity at 1-888-810-MSFT (6738).

Consult with a tax professional to make sure this is the right option for you given your individual tax situation.

Is Making an In-Plan Conversion Right for Me?

In-plan conversions provide the ability to accumulate more Roth funds which has several benefits:

- Roth funds can be withdrawn completely tax free under qualified circumstances. This reduces future taxes and also assists with tax planning in retirement since the amount of your taxable income will affect your Medicare premiums and the amount of your social security subject to taxation.
- Roth funds inside a Roth IRA are not subject to mandatory distribution at age 72 thus the account can be used as an estate planning tool to leave income tax free money to heirs. Roth funds inside a 401(k) are subject to mandatory distribution but that can be avoided by rolling the money into an IRA.

There are also potential drawbacks to making an in plan conversion:

- You must have money to pay taxes outside of the 401(k) plan. Taxable income can be minimized if you convert only after-tax (non Roth) funds and its associated earnings quickly. If a conversion is done soon after contribution, before significant earnings have accumulated, tax liability will be minimal.
- After-tax contributions can be withdrawn from your 401(k) anytime tax and penalty free. Associated earnings are subject to taxes and 10% penalty if you are under age 59½. This allows for flexibility in case you need the money for other purposes. If those funds are converted to Roth, you will no longer have unfettered access to the money. Roth funds are only tax and penalty free if the withdrawal meets qualified distribution guidelines.

In Plan Conversion

Benefits	Drawbacks
Completely tax free withdrawal from Roth funds	Must have money to pay taxes outside of the 401(k) plan
Good estate planning tool if Roth funds are not needed	Lack of withdrawal flexibility once converted to Roth funds

✓ EXERCISE

1. **Sanjay has $10,000 in after-tax funds in his 401(k) that has accumulated $50 in earnings. He can elect to do an in plan conversion of only the $10,000 after-tax deferral and not the $50 in earnings.**

   TRUE FALSE

2. **Emma wants to convert half of her $6,000 in pre-tax contributions that has $200 in earnings. She will be taxed on $3,200 for the conversion.**

   TRUE FALSE

3. **Tyrone started working for Microsoft 6 months ago and he wants to convert the employer match that he has received. Can he do that?**

   YES NO

Answers can be found on page 17.

Out-of-Plan Conversions

Because certain funds can be withdrawn from the 401(k) plan even while you are still employed with the company, it is possible to convert those funds into Roth but move them out of the plan and into a Roth Individual Retirement Account, instead of keeping them in the 401(k). Please call the Fidelity Service Center at 1-888-810-6738 if you want to initiate an out-of-plan conversion.

Distribution eligible funds that can be converted include:

- For current employees under age 59½: after-tax and rollover monies only
- For current employees age 59½+ or for former employees: all monies

Tax treatment is the same as for in-plan conversions: all taxable funds converted will be added to income in the year of conversion.

In-Plan vs. Out-of-Plan Conversions

When employees have the option of converting to Roth both within and out of the plan, it is worth giving some thought as to which option is more appropriate for you. Elements to consider include:

- **Funds Eligible for Conversion:** If you are a current employee under age 59½, in-plan conversions give you the option of converting pretax funds. That is not available for out-of-plan conversions.
- **Fees:** There are no account fees in the Microsoft 401(k) plan but there may be fees for an IRA. Investment fees in the 401(k) are low due to the size of the plan's assets. Investment fees in an IRA will vary depending on the investment and your account balance.
- **Investment Options:** The 401(k) has pre-vetted investment options as well as a brokerage link option which allows access to many investment choices. The options available through an Individual Retirement Account will differ depending on where the account is held. If held at a brokerage firm, the options are usually wide-ranging.
- **Legal Protection:** 401(k) plans are generally protected against creditors, civil lawsuits, and bankruptcy. IRAs may or may not offer the same level of protection depending on the state you live in.

Distributions and Rollovers

If you terminate employment with Microsoft, you have four ways to handle the 401(k) account:

1. **Withdrawal the money**

   Beware that those funds may be subject to income taxes and the early withdrawal penalty of 10% if you are under age 59½. Hence withdrawals are generally not recommended unless you meet one of the exceptions to the assessment of penalties. The next three options all avoid taxes and penalties.

2. **If the vested account balance is at least $1,000, you may leave the 401(k) at Microsoft**

3. **Rollover the account into a new employer's retirement plan**

   Please first check with the new plan to make sure that they accept rollovers. Also if you have unconverted after-tax (non Roth) money in the plan, make sure the new plan can accommodate those funds. Not all 401(k) plans allow after-tax (non Roth) contributions.

4. **Rollover the account into an IRA (individual retirement account), which you can open at any brokerage such as Vanguard, Schwab, and Fidelity**

   If your 401(k) funds contain both pre-tax and after-tax funds, you can roll the money into separate IRAs.

Split IRA Rollover

With an account that holds many types of contributions such as pre-tax, after-tax, and Roth, you can do a split rollover. Pre-tax contributions roll into a Traditional IRA. The Roth money rolls into a Roth rollover IRA. The after-tax money is split: the contributions go into a Roth IRA while the earnings go into a traditional account since the earnings are taxable. This is assuming you have not already converted all after-tax funds to Roth via an in plan conversion.

In Summary:

Roth 401(k) Contributions and Earnings➔ Roth IRA

Pre-Tax 401(k) Contributions and Earnings ➔ Traditional IRA

After-Tax (Non-Roth) 401(k)Contributions ➔ Roth IRA

After-Tax (Non-Roth) 401(k) Earnings ➔ Traditional IRA

With an IRA rollover, the after-tax contributions and earnings can be separated and treated differently for the transfer. There are no tax liabilities with a split IRA rollover since taxable money is NOT being converted to a Roth. With the after-tax contributions that are now in Roth accounts, a conversion has essentially taken place and all future earnings will be tax and penalty free if they are deemed qualified distributions.

Example

Charise has a 401(k) with $40,000 in pre-tax contributions, both from her payroll deduction and from vested employer contributions. Those funds have earnings of $8,000. She also has after-tax contributions of $10,000 with $400 in earnings, none of which has been converted to a Roth yet. Charise leaves her employer and wants to rollover the entire 401(k) balance into an IRA. Here is how her funds would transfer:

- Pre-tax contribution and earnings of $48,000 to a Traditional IRA
- After-tax contribution of $10,000 to a Roth IRA
- After-tax earnings of $400 to a Traditional IRA

In Service Split Rollover

It is possible to do a split IRA rollover with after-tax funds and their associate earnings as well as with rollover funds while still working for Microsoft. This is because Microsoft's 401(k) allows the withdrawal of after-tax funds and associated earnings at any time. The plan also allows the withdrawal of rollover funds (retirement funds from a previous employer) at any time. Hence an employee may choose to rollover those funds into an IRA while still working at the company as opposed to waiting until they leave the company. There is no limit to the number of rollovers you can do per year.

All or part of the after-tax funds and associated earnings can be rolled over into an IRA. Partial rollovers are prorated.

Example

There is $10,000 in the after-tax account, $8,000 is from contributions and $2,000 is from earnings. The employee elects to roll over $5,000. In this case, $4,000 will be deemed to come from contributions and rolled into a Roth IRA while $1,000 will be deemed as earnings and rolled into a traditional IRA.

Suggested Action Items

The following are suggestions only. Whether you wish to take action should be based on your own individual situation and circumstances.

1. Determine if you will be making after-tax, non-Roth contributions.

2. Save the amounts that work for your budget

3. Decide if you want to convert the funds to Roth.

4. Make an in-plan conversion if it makes sense financially (best to first consult with an experienced tax advisor)

Appendix

Online Retirement Calculators

Studies continually show that since people are healthier and living longer, many want to maintain the same standard of living as they had during their working years.

Perform Annual Calculation

In order to ensure you are on track for retirement, annually calculate your progress towards reaching your retirement goals. Afterward, make the necessary adjustments to the amount allocated to retirement savings. Contact former employers to determine if you are eligible for any retirement benefits. Get benefit estimates in writing.

Run both worst-case as well as best-case scenarios during your annual calculation. Please note, there is a wide range in quality with retirement calculators. Many calculators assume a constant investment and inflation return each year.

Assumptions

When performing calculations, assume:

Income Level - 70-80% of your annual pre-retirement income

Inflation Rate - 4% annually

Websites

Most 401(k) account offers a retirement savings estimator.

These additional websites offer online retirement calculators as well:

www.fidelity.com
www.kiplinger.com
www.troweprice.com
www.vanguard.com

Review the privacy policy before using free online financial planning tools.

Online Retirement Planning Advice

The following websites also offer retirement planning advice tools:

www.morningstar.com/save-for-retirement.html
www.consumerreports.org/cro/money/retirement-guide/index.htm

Financial Knowledge Network, LLC and your employer do not specifically endorse any of the websites or products listed above or recommend any one over any other. Retirement planning and advice tool results can vary from website to website due to the assumptions and variables involved. Make sure to consult with a qualified financial professional before taking action.

Form 1099-R

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and phone no.	1 Gross distribution $ 2a Taxable amount $	OMB No. 1545-0119 2020 Form 1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.	
	2b Taxable amount not determined ☐	Total distribution ☐	**Copy B** **Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.** This information is being furnished to the IRS.	
PAYER'S TIN | RECIPIENT'S TIN	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $		
RECIPIENT'S name	5 Employee contributions/ Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $		
Street address (including apt. no.)	7 Distribution code(s) | IRA/ SEP/ SIMPLE ☐	8 Other $ | %		
City or town, state or province, country, and ZIP or foreign postal code	9a Your percentage of total distribution %	9b Total employee contributions $		
10 Amount allocable to IRR within 5 years $ | 11 1st year of desig. Roth contrib. | 12 FATCA filing requirement ☐	14 State tax withheld $ $	15 State/Payer's state no.	16 State distribution $ $	
Account number (see instructions) | 13 Date of payment	17 Local tax withheld $ $	18 Name of locality	19 Local distribution $ $	

Form **1099-R** www.irs.gov/Form1099R Department of the Treasury - Internal Revenue Service

Organizations and Websites

American Association of Individual Investors www.aaii.com	*A not-for-profit corporation formed to help individuals become effective managers of their own assets through education and research.*
Ed Slott's IRA Advisor www.irahelp.com	*Provides a wealth of information regarding the latest trends and updates regarding IRA investments.*
Internal Revenue Service www.irs.gov/publications	*Offers tax information. Publications and forms can be downloaded, viewed, and printed, including the following related to this course topic:*

Publication 571: Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations
Publication 575: Pension and Annuity Income
Publication 939: General Rule for Pensions and Annuities

Investment Management Education Alliance https://imealliance.com/	*Provides links to fund companies, daily pricing of select funds, education library, and industry news.*
Kiplinger Finance www.kiplinger.com	*Offers stock quotes, mutual fund rankings, financials, frequently asked questions, and interactive resources.*
Money http://money.com/money/	*Features text from Money Magazine, guides to mutual funds, company reports, etc.*
Morningstar www.morningstar.com	*Provides mutual fund news and analysis, guides to fund families, stock quotes, and general market news.*
National Association of Investors Corporation (NAIC) www.betterinvesting.org	*A non-profit organization dedicated to investment education and assistance with forming investment clubs. Members receive the monthly magazine, Better Investing, which has beginner's articles and profiles of various companies.*
U.S. Department of Labor Pension & Welfare Benefits Administration www.dol.gov	*Provides assistance to employees seeking advice on employer retirement plans.*
Value Line www.valueline.com	*Provides investment research on stocks and mutual funds.*
Yahoo! Finance http://finance.yahoo.com	*Offers basic quantitative tools, market data, news and helps track stocks and funds.*

Any organizations or websites mentioned are not affiliated with Financial Knowledge Network, LLC. or your company.

Answers to Workbook Exercises

Page 9

1. False. The after-tax contributions must be converted with their associated earnings
2. False. Earnings will be prorated so Emma will be taxed on $3,100
3. Yes, Microsoft's plan now allows conversion of pre-tax funds that are vested

For formatting reasons, this page intentionally left blank.

1.7.21

SEND US FEEDBACK!

408.414.5050 info@financialknowledge.com www.financialknowledge.com