How to use a 401(k)-to-IRA rollover to boost a future health premium credit

An individual who is a participant in a 401(k) plan and who is planning on separating from service before normal retirement age, say at age 62, faces many choices. One key choice will be whether to keep his 401(k) account intact or roll it over to an IRA. Another choice for many will be whether to continue coverage under their employer's health plan for a fixed period (typically eighteen months) by choosing and paying for COBRA coverage or to purchase a policy on an exchange and potentially qualify for a premium assistance credit. For those who opt for the latter and who have made substantial nontaxable contributions to their 401(k) plan, the IRA rollover approach may help them boost their premium credit for coverage purchased on the exchange during the period before they become eligible for Medicare. That's because they can choose to roll over their entire 401(k) account balance less their aggregate after-tax contributions and withdraw those after-tax contributions tax-free at the time of the rollover. They can then use the after-tax amounts, along with relatively small taxable IRA distributions to live on, and secure a sizeable premium credit, as detailed in this *Practice Alert.*

Rollover decision. An employee who participates in a 401(k) plan and who retires early, say at age 62, has three choices as to what to do with his 401(k) funds: (1) leave them in the plan; (2) roll them over to an IRA (Code Sec. 402(c)(1)); or (3) cash out (i.e., receive a lump-sum distribution). If he is considering a rollover to an IRA and made after-tax contributions to the plan, he can roll them over to an IRA that accepts rollovers of after-tax contributions. (Code Sec. 402(c)(2)(B)) Alternatively, he can roll over the balance less the after-tax contributions and withdraw the after-tax contributions free of tax. (Code Sec. 402(c)(2) treats the amount transferred to the IRA as first coming from the taxable portion of the distribution. This is borne out by IRS Pub 475, Pension and Annuity income, which states "[if you roll over only part of a distribution that includes both taxable and nontaxable amounts, the amount you roll over is treated as coming first from the taxable part of the distribution.")

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If one does roll over 401(k) after-tax contributions to an IRA that accepts rollovers of after-tax contributions, the after-tax contributions become part of the individual's cost basis in the IRA. The individual should file Form 8606, Nondeductible IRAs, to ensure that the IRA is properly credited with the basis from the nontaxable contributions that were rolled over. (IRS Publication 575) Ultimately, when distributions are taken from the IRA, the basis will be recovered proportionately. Likewise, had the retiring individual kept his 401(k) plan instead of rolling over the funds to an IRA, basis from the after-tax contributions would be proportionately recovered when distributions are received.

Thus, as shown above, the rollover route offers an opportunity to withdraw all after-tax contributions to a 401(k) plan tax-free at one time. As shown below, this may help to gain a larger premium credit for an individual who decides to secure health insurance on an exchange after he separates from service, in our case, at age 62.

There are other factors such as fees and investment considerations, which may bear on a decision to roll over or retain a 401(k),

Maximizing a premium credit. The Patient Protection and Affordable Care Act (P.L. 111-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152)-collectively, the Affordable Care Act-provide a Code Sec. 36B credit that is designed to make health insurance affordable to individuals with modest incomes who are not eligible for other qualifying coverage, such as Medicare, or "affordable" employer-sponsored health insurance plans that provide "minimum value." The credit applies for tax years ending after Dec. 31, 2013.

To be eligible for a premium tax credit, an individual must be an "applicable taxpayer," which Code Sec. 36B(c)(1) defines as a taxpayer:

(1) with household income for the tax year between 100% and 400% of the federal poverty line (FPL) for the taxpayer's family size;

(2) who may not be claimed as a dependent by another taxpayer; and

(3) who files a joint tax return if married (within the meaning of Code Sec. 7703, see below).

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In Q&As on its website, the IRS has explained that eligibility for a certain year is based on the most recently published set of poverty guidelines at the time of the first day of the annual open enrollment period. Thus, the tax credit for 2014 is based on the 2013 guidelines, which (for residents of the 48 contiguous states and Washington, D.C.) are:

... $11,490 (100%) up to $45,960 (400%) for one individual.

... $15,510 (100%) up to $62,040 (400%) for a family of two.

... $23,550 (100%) up to $94,200 (400%) for a family of four.

For this purpose, household income is an individual's modified adjusted gross income plus that of every other individual in his family for whom he can properly claim a personal exemption deduction and who is required to file a federal income tax return. Modified adjusted gross income is the adjusted gross income on his federal income tax return plus any excluded foreign income, nontaxable Social Security benefits (including tier 1 railroad retirement benefits), and tax-exempt interest received or accrued during the tax year. It doesn't include Supplemental Security Income (SSI) (Code Sec. 36B(d)(2)).

As the IRS Q&As explain, the amount of the premium tax credit is based on a sliding scale. Those who have a lower income receive a larger credit to help cover the cost of their insurance. The higher one's income, the lower the amount of the credit. If the amount of the credit is more than the amount of an individual's tax liability, he will receive the difference as a refund. If an individual owes no tax, he can get the full amount of the credit as a refund. But caution is required as the law has a cliff whereby $1 over the limit can cause a big loss in the credit.

Thus, getting back to our retiree who leaves service at age 62 with a 401(k) account to which he made after-tax contributions, he can use the rollover strategy described above to withdraw the after-tax contribution all at one time tax-free. He can then use those funds to live on for the period before he becomes eligible for Medicare and thus maximize his premium tax credit if he secures health coverage on an eligible exchange. He may need to supplement the tax-free funds with some taxable distributions from his IRA or other sources to have enough to live in. Even so, this could provide a greater premium tax credit than would have been the case had he withdrawn funds from the 401(k) and only been able to recover basis pro-rata or had made the rollover of the entire 401(k) account and made distributions from the IRA. There, too, basis would only be recovered pro-rata. His income may be too high for a credit during the year of separation from service but the strategy could work for subsequent years.

> **RIA observation:** If the retiree also has a Roth IRA, he can withdraw funds from the Roth IRA without causing a reduction to his premium tax credit. While nontaxable social security benefits and tax-exempt interest are taken into account in determining eligibility for a credit and its size, nontaxable distributions from a Roth IRA are not.

To be sure, this strategy is not without costs. Rolling over after-tax contributions, instead of using this strategy, would provide an opportunity for continued tax-free growth on the contributions. (Likewise, withdrawing Roth IRA funds loses the opportunity to secure additional permanent tax-free growth of the funds removed from the IRA). An individual should take these considerations into account in developing a strategy to obtain a maximum premium credit.

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