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Tax & Estate Planning for Your Retirement Savings

WHAT'S INSIDE?

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Demystifying Roth 401(k)-to-Roth IRA Rollovers

Roth 401(k) contributions continue to grow in popularity. At the same time, more and more employees are leaving their jobs with many looking to roll over their Roth 401(k) accounts to Roth IRAs. Unfortunately, the tax rules for these rollovers are confusing and easily misunderstood. Roth contributions can also be rolled over from 403(b) and 457(b) plans, but for the sake of simplicity, this article will refer only to 401(k) plans.

Why Would an Account Owner Do a Roth IRA Rollover?

An employee separating from service with a Roth 401(k) account has several good reasons to transfer those funds to a Roth IRA rather than leaving the money in the plan, such as:

1. Roth 401(k) participants are subject to required minimum distributions (RMDs) during their lifetime, but Roth IRA owners are not.
2. The rules for getting qualified tax-free distributions from Roth IRAs are easier to satisfy than the comparable rules for Roth 401(k)s.
3. Non-qualified Roth IRA distributions are subject to ordering rules that are more favorable than the pro-rata rule that applies to non-qualified Roth 401(k) distributions.

Qualified vs. Non-Qualified Roth 401(k) Distributions

Once a decision is made to roll over Roth 401(k) dollars to a Roth IRA, the portion of the rollover consisting of Roth 401(k) contributions (and any in-plan conversions) is always available tax-free, but the availability of tax-free earnings may depend on whether the Roth 401(k) distribution is considered qualified. Keep in mind that only the employee's Roth 401(k) account is subject to the qualified distribution rules — *other 401(k) accounts are bound by different tax rules.*

A Roth 401(k) distribution is qualified if two requirements are met. First, there must be a triggering event, which includes reaching age 59½, disability (under the strict tax code definition) or death. This means that a Roth 401(k) distribution upon separation from service before age 59½ (and not on account of disability or death) cannot be qualified.

Second, a five-year holding period must be satisfied. The holding period begins on January 1 of the year the employee made her first Roth contribution to the plan from which the distribution is being made. Besides a Roth 401(k) contribution, the five-year clock starts running with a rollover of funds from another Roth 401(k) plan or even an in-plan Roth