New IRS Guidance on 401(k) Rollovers

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The IRS clarified the rules on rolling over after-tax money from a 401(k) to a Roth IRA.

Good news: If you have after-tax money in your traditional 401(k), 403(b), or other workplace retirement savings account, you can roll it over to a Roth IRA without paying taxes, as long as certain rules are met. A recent clarification from the IRS confirmed this. Previously, the rules weren't entirely clear. Now it is clear that you can roll after-tax money to a Roth IRA and pretax money to a traditional IRA and avoid creating taxable income. There is one catch: The after-tax and pretax balances must be rolled over at the same time, and in the same proportions as in the 401(k).

Some examples

Let's look at a two hypothetical examples of a 401(k) rollover to a Roth IRA.

Andrew is age 60, retired, and has $1 million in his 401(k): $800,000, or 80% is pretax, and $200,000, or 20%, is after tax. He wants to roll over $100,000 to an IRA and leave the remainder where it is. If he rolls over $80,000 to a traditional IRA and $20,000 to a Roth IRA, he will have no tax liability. That's because the proportion (80%) of pretax money rolled to the traditional IRA is equal to the proportion (80%) of pretax money in the 401(k). The $20,000 rolled to the Roth IRA is entirely after-tax money.

What if Andrew wanted to rollover $100,000 entirely into a Roth IRA? He could do that, but in this case, $80,000 would be considered a taxable Roth conversion, because 80% of his 401(k) balance is pretax money.

Why consider rolling over to a Roth IRA from a 401(k)?

After-tax money is after-tax money—whether it is held in a Roth IRA or in a traditional 401(k). This means you don't have to pay taxes on it when you withdraw it,[1] but there are some benefits to having it in a Roth IRA vs. in a traditional 401(k). Here are a few:

- **Taxes on earnings.** *Any earnings on after-tax money in a traditional 401(k) are taxed when withdrawn. Earnings in Roth IRAs generally aren't. So converting after-tax money to a Roth means you may be able to avoid taxes on those earnings.*

- **Investment choice***s. A Roth IRA may provide more investment choices than are typically available in an employer's plan, although an employer's plan may also offer institutionally priced investments not available in an IRA.*

- **Required distributions***. There are no minimum required distributions, also known as MRDs or RMDs, from a Roth IRA during your lifetime. Once you reach age 70½, you will need to start taking distributions from a traditional 401(k), unless you are still working at the company.*

Some employers do offer a Roth 401(k) option and allow participants to convert non-Roth assets into an in-plan Roth account, so check with your employer to see if it is an option.

In conclusion

The IRS has clarified the rules on rolling over after-tax money from a traditional 401(k) to a Roth IRA. But deciding whether to roll over your 401(k) isn't necessarily a straightforward decision. This is why we suggest that you carefully assess your situation, consider all your available options and the applicable fees and features of each before moving your retirement assets, and check with a tax adviser to help you make an informed decision.

1. A distribution from a Roth IRA is tax free and penalty free provided that the five-year aging requirement has been satisfied and at least one of the following conditions is met: you reach age 59½, become disabled, make a qualified first-time home purchase, or die.

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