401(k) Roth Rollovers to Roth IRA - Don't Forget the 5-Year Rule

Quick-Take: The holding period of a Roth 401(k) account is not 'tacked' onto a Roth IRA to which the 401(k) funds are transferred for purposes of determining if a *qualified distribution* can be taken from the Roth IRA.

Background: As has been frequently mentioned in the past, it appears from the SECURE Act 2.0 that Congress is intent on encouraging more individuals to invest in Roth retirement accounts. That intent is not so much due to Congress's benevolence, as it is its desire to generate current tax revenues. With this renewed emphasis on Roth retirement savings, e.g., make-up retirement plan contributions must be to Roth retirement accounts per SECURE Act 2.0, we can expect more folks in their near-retirement working years who want to make 'catch-up' contributions to have 401(k) Roth accounts. Sometimes overlooked is the 5-year rule that could come as a surprise to Roth 401(k) participants.

5-Year Rule: Recall that for a distribution from a Roth IRA to be a tax-free *qualified distribution,* two separate 'tests' must be met. *Qualified distributions* are distributions that occur after (i) a five-year waiting/seasoning period has elapsed; and (ii) a 'triggering event' has occurred. The five-year waiting period can present a surprise to an individual who has contributed to a Roth 401(k) account for several years, and upon retirement rolls those Roth 401(k) funds to a newly opened Roth IRA.

A *qualified distribution* from a Roth 401(k) account means that the participant owned a Roth 401(k) account for 5 years and attained age 59 ½ years or older when the distribution is taken If either of these conditions does not exist, then it is a *non-qualified* distribution from the Roth 401(k) account.

Example: Ross meets the requirements for a *qualified distribution* from his Roth 401(k) account with Ross's employer. Ross retires. Ross rolls all his Roth 401(k) funds into a small Roth IRA that Ross opened 10 years ago. With Ross's 401(k) rollover, all former Roth 401(k) dollars pass into Ross's Roth IRA as tax *basis* and thus all these funds are immediately available for distribution tax-free, along with any future earnings on those rollover funds. Restated, all of Ross's 401(k) goes into Ross's Roth IRA as one large *basis* contribution, and Ross will always have access to those dollars continuously as his contributory Roth IRA funds, i.e., Ross will not face any income tax consequences.

Example: Rosie has contributed to her employer's Roth 401(k) plan for several years. However, Rosie has never opened a Roth IRA account. Rosie retires. Rosie promptly opens a Roth IRA into which Rosie plans to transfer all her Roth 401(k) funds. This will be a *qualified distribution* from the 401(k) plan, and all the dollars rolled over to Rosie's Roth IRA will be available to her, as tax-free *basis*. However, since it is a new Roth IRA, just having been opened by Rosie, and Rosie never had any other Roth IRA accounts before, there will still a 5-year holding/seasoning period requirement to be met before any subsequent earnings distributed to Rosie will be tax-free. While the rollover amount will be available to Rosie tax-free, not the future earnings of Rosie's Roth IRA, not until at least 5 years have passed.

No 'Tacking' the Roth 401(k) 5-years: To summarize, the 5-year holding period that is required to satisfy the Roth *qualified distribution* rules is the holding period for the Roth IRA. Any holding period for the owner's Roth 401(k) account will not get 'tacked on' to the required 5-year holding period precondition for the Roth IRA to which the 401(k) funds are rolled. The 5-year holding rule applies only to the Roth IRA, not to the Roth 401(k).

Roth Taxation Ordering Rules: While the 5-year holding period for a 'just opened' Roth IRA to receive the Roth 401(k) distribution may come as a surprise to the plan participant, its severity is greatly minimized by the Roth taxation ordering rules. Any distribution from a Roth IRA is deemed to come from specific sources within the individual's aggregated Roth IRAs in a certain order. [IRC 408A(d)(4)(B); Regulation 1.408A-6,A-8.] These ordering rules apply to all Roth IRA distributions except for either corrective distributions, or Roth IRA-to-Roth IRA rollovers. Distributions from a Roth IRA are, made (or taxed, so to speak) in the following order or priority:

1. Distributions from a Roth IRA are deemed to consist first of regular contributions i.e., tax-free *basis,* and only thereafter earnings. [Regulation 1.408A-10, A-3(a).]

2. A *qualified designated Roth account,* known by the horrible acronym as a DRAC, is a distribution from a Roth 401(k) or Roth 403(b) plan, that is rolled into a Roth IRA. A DRAC is treated as a regular contribution, i.e., tax-free *basis,* to the Roth IRA for purposes of rule #1. [Regulation 1.408A-10, A-3.]

3. If the Roth IRA received any rollover contribution that was a non-qualified distribution from a DRAC, then the participant's after-tax contributions to the DRAC are considered 'regular' contributions to the Roth IRA, i.e., tax-free *basis.* The portion of the rolled over distribution allocable to earnings in the DRAC is allocated to earning in the Roth IRA, i.e., it moves to category #5 below. [Regulation 1.408A-10, A-3.]

4. If the 401(k) distribution exceeds the total of the participant's regular Roth 401(k) contributions, the distribution is deemed to come next from the participant's 'conversion' of contributions on a first-in, first-out basis. Once it is determined pursuant to the prior sentence that the distribution is deemed to come from a particular 'conversion' contribution, the dollars that were includible in the participant's gross income by virtue of the conversion are deemed distributed first. The part that was not includible in the participant's income would still not be includible in income. This rule only applies to a participant who is under the age 59 ½ at the time of the Roth distribution.

5. Finally, once all contributions have been distributed, the balance of the distribution comes out of earnings and are taxed to the Roth IRA owner.

To summarize, with a non-qualified distribution, former Roth 401(k) dollars will maintain their same character when they are rolled into the Roth IRA, i.e., most will be tax-free. Those salary deferrals will be treated as tax *basis,* while 401(k) earnings will be characterized as Roth IRA earnings. The required 5-year holding period for the Roth IRA will apply, but the first distributions out of the Roth IRA will be treated as tax-free *basis.*

Example: Ray participated in his employer's Roth 401(k) plan for the four years prior to Ray's retirement. Ray did not have a Roth IRA during those years. Ray elects to roll his Roth 401(k) account to his newly opened Roth IRA. Ray's 4 years of participation in his employer's Roth 401(k) plan are lost. The Roth IRA holding/seasoning rule takes precedence. Had Ray opened a Roth IRA in a nominal amount 5 years earlier, then when his Roth 401(k) balance was rolled into his Roth IRA would have caused all the earnings on Ray's Roth IRA account, from day-one forward, to be tax-free. Since Ray had not opened a nominal Roth IRA a few years earlier, if he withdraws any post-rollover earnings from his Roth IRA at any time in the 5 years after his retirement, some of those earnings to Ray will be taxed.

Conclusion: A Roth IRA has its own 5-year holding mandatory rule that must be satisfied, regardless of whether funds are rolled into that Roth IRA from a Roth 401(k) account. There is no 'tacking' of the Roth 401(k) period onto the Roth IRA 5-year holding requirement. Fortunately, if funds are needed by the Roth IRA owner within 5 years of that Roth 401(k) rollover, the first funds distributed from the Roth IRA to its owner will constitute a tax-free *qualified distribution*, meaning *basis.* It is only after all *basis* has been distributed from the Roth IRA to its owner, within the 5 years after the Roth 401(k) rollover before there exists that possibility that post-rollover Roth earnings might be subject to tax when distributed to the Roth IRA owner. In sum, when advising an individual who has a Roth 401(k) account, it will be important to alert them to the 5-year holding period, and it might be wise to open a nominal Roth IRA account now, in anticipation of a future rollover into that account of a much larger Roth 401(k) amount.

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