

Roth 401(k) Accounts- Different Distribution Rules

Quick-Take: Do not assume that Roth IRA distribution rules are the same as Roth 401(k) distribution rules. These different rules can cause unexpected tax consequences.

Background: Prior missives have touched upon a couple of the differences between a Roth IRA and a Roth 401(k) account. These differences should start to get more attention now that starting this year some 'catch-up' 401(k) contributions must be in the form of a Roth (i.e., after-tax) contributions to a Roth 401(k) account.

SECURE 2.0 Act: The 2022 SECURE Act added a new provision to the Tax Code. The Act requires mandatory Roth 401(k) contributions, i.e., after-tax contributions, for the catch-up contribution amount to a Roth 401(k) account, if the plan participant had reportable FICA earnings (reported on a W-2) in the prior year of at least \$150,000. That rule applies in 2026. Consequently, a plan participant's catch-up contribution for 2026 (\$8,000) or the 'enhanced-catch-up' amount for those between the ages of 60 and 63 (\$11,250) must be made with after-tax dollars.

Back to (Roth) Basics: To repeat earlier missives, to take distributions from a Roth IRA tax-free, two conditions must be met: (i) the Roth distribution must either be after the owner has attained the age 59 ½, or the distribution is at death, or is for a disability, or for a first-time home purchase; and (ii) the owner must have satisfied the 5-year holding period. The 5-year holding period starts on January 1 of the year that the first contribution was made by the owner to the Roth account. If these two conditions are met, distributions from the Roth account are both tax-free and penalty-free. at any time.

Favorable Roth Ordering Rules: If one or both of the above conditions are not met, then distributions from the Roth account *may* be taxable depending on the amount withdrawn from the account. Three different components can comprise a Roth distribution: (i) Roth contribution dollars; (ii) Roth conversion dollars if an IRA/401(k) is converted to the Roth account; and (iii) earnings on those Roth contributions. However, the Roth owner is protected by favorable 'ordering rules' when a distribution is taken from a Roth account.

Those ordering rules are: (a) first dollars withdrawn are the Roth contribution dollars, which are tax-free to the owner; (b) next to be withdrawn are any Roth conversion dollars, also tax-free to the owner; and (c) last to come out are earnings on the Roth contributions, which may be tax-free, or may not tax-free if either of the two conditions identified above are not met.

Note that all Roth IRAs owned are considered to be a single Roth account owned by the IRS, so that if one Roth account was funded 5+ years ago, and another Roth account was recently opened, the 5-year rule will be deemed to be satisfied for both Roth IRAs, so a distribution from the last Roth IRA, even if not established for more than 5 years, will still be tax-free to the owner.

Distribution Penalty: While the Roth ordering rules are beneficial to the account owner, with both the contributions and conversion dollars being distributed first, and thus tax-free, once those amounts are depleted in Roth distributions to its owner, if earnings begin to be taken by the owner from the Roth account, the 10% early distribution excise tax could apply, along with income taxes imposed on the 'earnings' distribution if the two conditions previously identified (at least age 59 ½ and 5+ years of Roth account existence) have not been met.

Roth 401(k) Rules: Leave it to Congress to use a different set of rules for Roth 401(k) accounts, as if the original Roth rules were not complicated enough! Some of these different rules include the following:

No First Home Buyer Exception to the Age 59 ½ Requirement: Unlike a Roth IRA, there is no first-time home purchase exception to the age 59 ½ condition with respect to a Roth 401(k) account.

Each Plan Has Its Own 5-Year Holding Period: The Roth 401(k) owner must satisfy the 5-year holding period, but unlike a Roth IRA where one Roth IRA that has a shelf-life of over five years satisfies that requirement for all of the owner's Roth IRAs, each Roth 401(k) account has its own 5-year holding period associated with that separate qualified plan. Consequently, if the employee participates in two separate qualified plans, each

permitting (or requiring) Roth contributions to the 401(k) account, each of those plans' 5-year holding periods must be satisfied before distributions can be distributed to the owner income tax-free.

Roth 401(k) Rollout to Roth IRA: As was pointed out in an earlier missive, if a Roth 401(k) account is rolled out of the qualified plan and into a new Roth IRA, that starts a 5-year holding period for that new Roth IRA. Restated, the five years that the Roth 401(k) was in existence does not follow over to the new Roth IRA; the new Roth IRA that received the rollover amount must start its own 5-year holding period for purposes of tax-free distributions and possible early distribution penalties.

Roth 401(k) Pro Rata Distribution Rules: The favorable ordering distribution rules for Roth IRAs do not apply to distributions from a Roth 401(k) account. A distribution from a Roth 401(k) account uses a *pro rata* mix of after-tax contributions and pre-tax earnings dollars, if the plan participant is either under the age 59 ½ or his/her 401(k) account has not been in existence for at least 5 years. If these two conditions are met and the Roth 401(k) distribution is rolled out into a Roth IRA, there will be no tax or penalty on distributions, as it will be treated in its entirety as an after-tax 'contribution' and thus the distribution can be taken from the Roth IRA tax-free. However, if the participant is under the age 59 ½, or he/she has not maintained their Roth 401(k) account for at least 5 years, a distribution from the Roth 401(k) account will be a mix of contributions and earnings, i.e., *pro rata*. In other words, the plan participant cannot just isolate their after-tax Roth contributions for purposes of a distribution from their Roth 401(k) account; each distribution will include a portion of the Roth after-tax contribution/salary deferral, and pre-tax earnings on those contributions. In short, if either the age 59 ½ condition or the 5+ year holding period condition is not satisfied, then the distribution could be both taxable and possibly subject to the 10% excise tax. If the distribution is rolled over from the Roth 401(k) account to the owner's Roth IRA account, the after-tax contribution portion goes into the Roth IRA after-tax contribution portion, and the Roth 401(k) pre-tax earnings pass to the pre-tax earnings portion of the Roth IRA.

Example: Rose started working for her new employer three years ago at age 58. Rose participated in her new employer's Roth 401(k) plan making contributions to that account. Four years later, Rose decides to retire and take Social Security retirement 'early.' Rose has thus maintained her Roth 401(k) account for four years. Rose rolls her Roth 401(k) account

balance to a new Roth IRA. That rollover amount to Rose's Roth IRA consists of both Rose's after-tax salary deferral contributions along with pre-tax earnings on those salary deferral contributions. Therefore, the contributions portion coming to Rose's Roth IRA will retain its after-tax classification, and the earnings portion of Rose's rollover amount will retain its pre-tax classification. If Rose takes a large distribution from her 'new' Roth IRA to supplement her Social Security benefits, some of the distribution may be taxable if it comes out as part of the earnings portion- her Roth IRA has not been in existence for 5+ years.

If Rose had maintained a Roth IRA for decades earlier, albeit with only a nominal amount, it's 5-year+ duration could be used by Rose so that even if she withdrew the earnings from her Roth IRA after the rollover of the entire 401(k) account balance to her existing Roth IRA, those 4+ year earnings would not be taxed when they were taken by Rose.

Conclusion: While our tendency is to treat all Roth accounts the same, that is a mistake, especially when it come to taking distributions from the Roth account, e.g., ordering rules for Roth IRA distributions vs *pro rata* distributions for Roth 401(k) accounts. My recurring lament: Why can't Congress just come up with a single set of rules that apply to all types of retirement accounts for both contributions and distributions, either pre-tax or Roth? The rules do not need to be nearly this complicated (or contradictory.)

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