



After-tax 401(k) rollover to Roth IRA OK'd

By Chris Kissell • Bankrate.com

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Millions of employees have had the option to make after-tax contributions to their traditional 401(k) plans for many years -- long before the Roth 401(k) came on the scene. Now, a recent IRS ruling makes it easier to do an after-tax 401(k) rollover to a Roth IRA.

The ruling potentially will benefit many workers, especially those whose incomes make them ineligible to contribute to a Roth IRA annually.

401(k) contribution rules

On a pretax basis, employees can't contribute above certain limits. In 2015, for instance, the limit is \$18,000; those 50 and older can make additional catch-up contributions of \$6,000. This money is not counted toward income, and all gains are tax-deferred. The limits are the same for Roth 401(k)s, though the contributions do count toward income and all gains are tax-free.

But employees can sock away a lot more retirement cash if their company plan offers an after-tax option in a traditional 401(k). For instance, the IRS established a limit of \$53,000 for individuals in 2015.

Thanks to the recent IRS ruling, employees now can more easily roll over after-tax contributions into a Roth IRA when they retire, or after leaving their company.

"In essence, you can now contribute over \$50,000 per year into your Roth IRA," says Brian Frederick, CFP professional at Stillwater Financial Partners in Scottsdale, Arizona.

Clarifies and streamlines the process

In recent years, a growing number of employees retiring or separating from their company have tried to avoid future taxes on gains altogether by rolling their after-tax contributions into a Roth IRA. But because IRS rules on the matter were so murky, employees typically had to jump through a series of hoops to accomplish their goal -- and in the end, they often had to pay some taxes to complete the rollover.



"There was no clear guidance on how to accomplish it without incurring taxes," says Erik Klumpp, CFP professional and founder of Chessie Advisors in Rochester Hills, Michigan.

The new IRS ruling makes the process easier and more transparent, says Andrew Novick, CFP professional and founder of the Investment Connection in Center Valley, Pennsylvania.

"The new rule makes it clear that it can be done as a direct rollover," he says. "This eliminates the risk of problems with the IRS later."

Who benefits?

The new rule will benefit various types of investors, especially high-income earners who make too much money to be eligible to contribute to a Roth IRA in the standard way.

For instance, in 2015, you cannot make a full contribution to a Roth IRA if you are an individual whose income is more than \$116,000, or a married couple whose combined income is more than \$183,000.

Contribution limits for IRAs are \$5,500 a year, plus an extra \$1,000 if you're 50 or older, piling in comparison with 401(k) limits.

"High-income earners who have been phased out of contributing to a Roth are now able to get into a Roth IRA with ultimately no out-of-pocket costs," says Steve DeCesare, CFP professional and founder of DeCesare Retirement Specialists in Marlton, New Jersey.

Others who may benefit include:

- People who would like to contribute more to a Roth, but whose companies do not offer a Roth 401(k) plan.
- People who made after-tax contributions to their traditional 401(k) plans throughout the 1980s and 1990s, before the advent of the Roth IRA and Roth 401(k).
- People who want to build up a Roth IRA with the goal of passing it on to heirs. Upon separation from their company, these employees can roll the after-tax funds into a Roth IRA so they will not be required to take required minimum distributions during their lifetime. That leaves a bigger pile of money for heirs.
- People who already make the maximum contribution to all their tax-advantaged retirement accounts and simply want to save more.
- People who have delayed saving for retirement and need to save more than standard 401(k) and IRA limits currently allow.

It is important to note that for most workers, the new rule will not come into play until they retire or separate from the company associated with their 401(k) plan.

"Participants can now contribute after-tax money knowing that it is a way to build up a Roth IRA once they retire or leave the company," Klumpp says.

In addition, the new ruling only affects participants who make after-tax contributions to a traditional 401(k) plan, as opposed to a Roth 401(k). Participants in a Roth 401(k) plan already can roll their funds into a Roth IRA upon departure from their company.

How it works

The new rule went into effect on Jan. 1, 2015, but the IRS says it effectively applies to

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distributions made on or after Sept. 18, 2014.

If you plan to roll over your entire 401(k) balance, the rules are pretty straightforward.

"The plan administrator will distribute the funds per the wishes of the investor in two separate checks -- one representing pretax contributions to their (traditional) IRA, the other after-tax contributions converted to their Roth," DeCesare says.

Partial distributions of your 401(k) balance are trickier. Novick cites the example of an employee who has \$100,000 in a 401(k), with \$80,000 coming from pretax contributions and \$20,000 coming from after-tax contributions.

"The new guidance doesn't allow you to really isolate the after-tax portion and just roll that portion over to a Roth IRA," Novick says. "A participant can't take a distribution of \$20,000, claim the entire amount consists of after-tax contributions and roll it into a Roth IRA."

That would run afoul of the Roth IRA conversion "pro-rata rule." Instead, you must roll over a proportionate amount of both pretax and after-tax funds relative to the value of the entire account.

For example, the above account is made up of 80 percent pretax funds and 20 percent after-tax funds. Therefore, a \$20,000 partial distribution must be split into a \$16,000 pretax portion and \$4,000 after-tax portion.

The only way to roll over all of the after-tax portion into a Roth IRA is to roll over the entire 401(k) account, not just part of it, Novick says.

Before rolling over after-tax 401(k) dollars into a Roth IRA, it is important to make sure you carefully complete the proper paperwork, Novick adds.

"Since the concept is new, I'm guessing that many plan administrators might not be aware of the ruling yet," he says. "(They) might not have forms that specifically allow for the after-tax portion to be rolled into a Roth IRA."

If your plan administrator balks at your request, Novick urges you to forward a copy of the new IRS rules -- "and keep fighting!"

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