Money Matters

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Skloff Financial Group Question of the Month: 401(k) Rollover with After-tax and Pre-tax Balances

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Q: I am ready to rollover my 401(k) to an Individual Retirement Account (IRA) and was informed some of the money is after-tax and some is pre-tax. How can I complete the rollover on a tax-free basis?

The Problem – A 401(k) with After-Tax and Pre-tax Balances
Based on the type of 401(k) you have, you may have some money that has never been taxed (pre-tax) and some money that has already been taxed (after-tax). Previously, the IRS was vague on the ability to complete this type of rollover.

The Solution – IRS Guidance Notice #2014-54
Effective January 1, 2015 and retroactive to September 18, 2014, IRS Guidance Notice #2014-54 provides clear guidance on the ability to complete the rollover of after-tax money to a tax-free tax shelter. Specifically, pre-tax balances can be rolled over to a Traditional IRA or Rollover IRA, while the after-tax balance can be rolled over to a Roth IRA. The after-tax balance should not be confused with Roth 401(k) contributions. We address all three contribution types below.

Pre-tax 401(k) Contributions
You are generally permitted to contribute to your 401(k) plan based on the 2019 IRS limits: $19,000 per year for those under age 50 and $25,000 per year for those 50 years of age and older. Many 401(k) plans offer the ability to make these contributions on a pre-tax basis only. Taxes on principal, interest, dividends and capital gains are **deferred** until you begin making withdrawals. Withdrawals are taxed at your federal and or states income tax rate(s) in the year of the withdrawal. You may be able to defer taxes when your income tax rate(s) are high by contributing on a pre-tax basis and take withdrawals when your income tax rate(s) are low, such as in retirement.

Roth 401(k) Contributions
Some plans allow you contribute to a Roth 401(k), subject to the same contributions limits described above. Although your contributions are taxed before entering your account; principal, interest, dividends and capital gains are **tax free** (not deferred) when withdrawn. You may be able to pay lower taxes now in order to avoid what would have been higher taxes when you take withdrawals.

Since the IRS places modest contributions limits (subject to income bands) on Roth IRAs, Roth 401(k) contributions provide a backdoor means to accumulate future Roth IRA balances following an IRA rollover. Roth 401(k) balances (including principal and gains) can be rolled over to a Roth IRA, where withdrawals are also **tax free**. Furthermore, Roth IRAs are not subject to required minimum distributions (RMDs) for the original owner or the surviving spouse. Avoiding RMDs is a valuable income and estate planning strategy.

After-tax 401(k) Contributions
Prior to the advent of the Roth 401(k) some 401(k) plans allowed after-tax 401(k) contributions. Post the advent of the Roth 401(k) some plans still do not offer a Roth 401(k) - since it is not mandatory. Lastly, some plans allow for pre-tax, Roth and after-tax contributions. Combined contributions from all three sources cannot exceed the 2019 IRS limit of $56,000 for those under age 50 and $62,000 for those 50 years of age and older. Based on your age, after-tax contributions allow you to more than double the contribution limits of pre-tax and Roth 401(k) plans.

Since the IRS places modest contributions limits on Roth IRAs (subject to income bands), after-tax contributions provide a backdoor means to accumulate future Roth IRA balances following a rollover. Unlike a Roth 401(k), only the principal portion (not gains) of post-tax contributions can be rolled over to a Roth IRA. The same **tax free** withdrawals rules and RMD rules described above apply to this type of Roth IRA rollover. IRS Guidance Notice #2014-54 clearly allows for after-tax contributions to be rolled over to a Roth IRA.

Action Steps – Understand the Three Types of Contributions Your 401(k) Plan Offers Before and After Completing a Rollover
Work closely with your Registered Investment Adviser (RIA) to determine which types of contributions your 401(k) plan offers and which type(s) of contributions are in your best interest. Before completing a rollover evaluate what type of balances you have accumulated and which balances can be rolled over into which types of IRAs. Rollover mistakes can be costly to you and your heirs.

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