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Understanding your distribution options with your designated Roth account

Certain qualified employer sponsored retirement plans (QRPs) such as a 401(k), 403(b), or governmental 457(b), may offer employees an opportunity to make after-tax salary deferral contributions to a designated Roth account along with the traditional before-tax salary deferral option. The Roth option allows you to make after-tax contributions and have any potential earnings grow tax-free. Upon separation from service, you have a few choices for this money, and there may be tax and penalty implications depending on your distribution choice.

Qualified and nonqualified QRP designated Roth account distributions

Much like Roth IRAs, distributions from designated Roth accounts could be ***qualified*** or ***nonqualified***. Earnings are not taxed and there is no 10% IRS additional tax with qualified distributions. Nonqualified distributions may be subject to tax and an additional 10% pre-59½ tax (10% additional tax). However, it's important to note the ordering rules that apply to Roth IRA distributions do not apply to QRP designated Roth distributions. The following are rules for designated Roth account distributions:

- A qualified distribution, which is tax-free and not included in gross income, occurs when your designated Roth account has been open for more than 5 years **and** you are at least age 59½, you are disabled, or the payment is made to your beneficiary after your death.
- The 5-year holding period for a qualified distribution begins January 1 of the first tax year for which you funded your designated Roth account.
- Nonqualified distributions are taxed on a pro-rata basis. A portion of the distribution will come from the after-tax contribution and a portion from the before-tax earnings. Remember, the earnings are subject to income tax and perhaps the 10% additional tax.
- The QRP administrator is responsible for tracking the 5-year participation period and designated Roth contributions.

Distribution options

Generally, a triggering event such as separation from service or plan termination is required to receive a distribution from the QRP. Your distribution options are:

Keep in former employer's plan—If the plan allows this option, you do not need to make an immediate decision on where to move your retirement savings, and the assets retain their tax-free growth potential. You will be subject to that plan's rules regarding topics such as investment choices, distribution options, and loan repayment. Also, unlike a Roth IRA, QRP designated Roth accounts are subject to required minimum distributions (RMDs) generally beginning at age 72.

Roll to new employer plan—If you are joining a new company, rolling your designated Roth account to your new employer's plan may be an option, if your new plan offers a Roth feature.

- **Direct Rollover**—Your designated Roth account can be directly rolled over to your new employer's designated Roth plan. Your former employer's plan must separately account for the after-tax contributions and earnings and report this to your new employer's plan, if the distribution is not qualified. Your 5-year holding period can continue in your new plan as long as your former plan administrator has provided that information to your new plan administrator.
- **Indirect rollover**—If an indirect or 60-day rollover is selected, only the taxable amount (earnings) is allowed to be rolled to your new designated Roth account. You could roll the non-taxable amount (contributions) to a Roth IRA. The taxable amount of your distribution will be subject to a mandatory 20% federal income tax withholding, which you will need to make up out-of-pocket if you chose to roll over the entire taxable amount to your new employer's QRP. Your 5-year holding period for qualified distributions from your new QRP will begin whichever is earlier: January 1 of the year you roll over or January 1 of the year you make a Roth contribution to the new QRP. That is, you cannot carry over your former QRP's years you have accumulated.

Lump-sum distribution—This option may sound attractive at first, but you should carefully consider all of the financial consequences before deciding to cash out your retirement savings. The entire distribution will be tax-free for qualified distributions. A nonqualified distribution will be taxed on a pro-rata basis as previously discussed. Speak with your Financial Advisor and tax professional before taking a lump-sum distribution, as it could have a detrimental impact on your financial future.

Roll to Roth IRA—This can be accomplished by a direct rollover or an indirect—60-day—rollover. Once you roll to a Roth IRA, Roth IRA rules apply to these amounts. This means there will be no RMDs due during your lifetime, and if you have not had a Roth IRA for more than 5 years and you are age 59½, are disabled, or using the first-time homebuyer exception, the Roth IRA ordering rules for nonqualified distributions will apply. The ordering rules dictate that distributions are removed in this manner: first—all Roth IRA contributions, second—all Roth IRA conversion amounts, third—Roth IRA earnings. A rollover of a qualified distribution from a designated Roth account to a Roth IRA will be considered contributions for the Roth IRA ordering rules. When rolling over a nonqualified designated Roth account distribution, the designated Roth account contributions will be treated as Roth IRA contributions and the designated Roth account earnings will be treated as Roth IRA earnings. When rolling your QRP designated Roth account, keep the following in mind:

- **Direct Rollover**—A direct rollover to a Roth IRA protects your retirement savings from potential tax and 10% additional tax and continues the tax-free growth potential until you take distributions.
- **Indirect rollover**—With an indirect rollover to a Roth IRA, the taxable amount (the earnings) is considered to have been rolled first but contributions can also be rolled. The taxable amount is subject to a mandatory 20% federal income tax withholding. Please note that being able to roll both earnings and contributions to a Roth IRA is different than when executing an indirect rollover into a new QRP-designated Roth account. In that situation, only the earnings are permitted to be rolled over to the new designated Roth account.

Hypothetical case studies

Ruth, age 53, works for XYZ Corporation and contributed $8,000 to her 401(k) designated Roth account since 2013. Today it is worth $12,000.

Ralph, age 61, also works for XYZ Corporation and has contributed a total of $20,000 to his Roth account since 2013. Today it is worth $30,000.

Rollover to new employer's designated Roth account hypothetical examples

Direct rollover

Ralph left XYZ Corporation and elects a direct rollover to his new employer's designated Roth account. He will be able to roll the entire $30,000 to his new Roth account because he chose the direct rollover option.

Indirect rollover

Ruth has left XYZ Corporation and chooses a 60-day indirect rollover to her new employer's designated Roth account. Only Ruth's $4,000 of earnings will be rolled to the plan. Since this is not a qualified distribution, the $4,000 of earnings is subject to a 20% mandatory federal income tax withholding of $800. Her $8,000 contribution would not be allowed to roll over to her new plan. She would owe no tax or 10% additional tax on the $8,000 contribution that will be distributed directly to her. Ruth could roll the $8,000 to a Roth IRA within 60 days. Remember, her years of participation in XYZ Corporation's Roth do not carry over to her new employer's designated Roth account. Instead, the 5-year clock starts over for Ruth. It does not start over for Ralph because he elected a direct rollover.

Lump-sum distribution hypothetical example

Nonqualified designated Roth account distribution

Ruth has left XYZ Corporation and elects a lump-sum distribution. Although she has been in the plan for 5 years, it is not a qualified distribution because she is only 53. She will owe tax and the 10% additional tax only on the $4,000 of earnings, and the 20% mandatory withholding applies. The $8,000 is a return of the after-tax contributions with no tax withholding required.

Qualified designated Roth account distribution

Ralph leaves XYZ Corporation and elects a lump-sum distribution as well. Since his Roth 401(k) was opened over 5 years ago and he is over age 59½, this is a qualified distribution. He will owe no federal income tax or 10% additional tax. No 20% tax withholding applies.

Rollover to Roth IRA hypothetical example

Direct rollover to existing Roth IRA

Ruth elects a direct rollover to her Roth IRA, which she opened at Wells Fargo Advisors in 2019. The Roth IRA is worth $13,500, of which $12,500 is from Roth IRA contributions and $1,000 is earnings. Since her Roth 401(k) rollover is nonqualified, the $8,000 will be treated as part of her Roth IRA contributions now totaling $20,500. The $4,000 of earnings will be treated as Roth IRA earnings for a total of $5,000. The 5-year holding period for the Roth IRA will be satisfied on January 1, 2025, but she will only be age 57. So for her earnings to be distributed tax- and additional tax-free from the Roth IRA, she will need to wait until she is age 59½.

Direct rollover — no previous Roth IRA

Ralph elects a direct rollover to his Roth IRA he just opened at Wells Fargo Advisors. Since the $30,000 is a qualified Roth plan distribution, it will be treated as a Roth IRA contribution. Even though he is 61, he has not had a Roth IRA for 5 years. Any distribution above the $30,000 will be taxed if distributed prior to the end of the 5-year Roth IRA holding period. He will have no 10% additional tax on the earnings since he is older than 59½. Please note that the Roth 401(k) 5-year holding period does not count towards the Roth IRA 5-year holding period.

Talk to Wells Fargo Advisors

Remember that unless you are separating from service, your QRP will dictate when you can take distributions. What to do with the money you have accumulated in your QRP can be one of the most important decisions in your life. At Wells Fargo Advisors, we understand the significance of retirement planning and we hope this fact sheet will help you to clarify your options.

Website
wellsfargoadvisors.com

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