MANAGING YOUR FINANCES

When It's Time to Tap a Roth 401(k)

THE ROTH 401(K) IS A POWERFUL SAVINGS VEHICLE THAT can deliver a tax-free pot of money in retirement. Such a stash "gives you some future control" over your tax bill, says Chris Chaney, vice president at Fort Pitt Capital Group, in Pittsburgh. You can tap it for, say, a new roof or moving expenses, without upping your taxable income. But there are hurdles to overcome to keep Uncle Sam away from your Roth 401(k) money.

The Roth 401(k) became a savings option a decade ago. Now that workers are beginning to take money out of Roth 401(k)s, they are learning that the rules are not exactly the same as those covering Roth IRAs.

One key difference: While the original owner of a Roth IRA never has to withdraw funds, Roth 401(k) owners must take required minimum distributions (RMDs) each year upon turning age 70½.

To tap earnings tax- and penalty-free, you generally must meet two tests. First, you must be 59½ or older. And second, the Roth 401(k) must have been open for at least five years.

That might sound like the same rule that applies to Roth IRAs, but there's a catch. With the IRA version, the first Roth you open starts the five-year clock ticking for any other Roth IRAs you open. With Roth 401(k)s, each plan is treated separately, says Denise Appleby, of Appleby Retirement Consulting, in Grayson, Ga. If you retire after holding a Roth 401(k) for three years, for instance, the money must sit for another two years to be fully tax-free—even if you have an older Roth 401(k) from a previous employer that meets its five-year test.

A workaround: When switching employers, have the money from your old Roth 401(k) rolled directly into the new company's Roth 401(k). With a direct rollover, the age of the account transfers along with the money, so you won't have to satisfy a fresh five-year clock.

Another difference is how withdrawals are treated before the twin tests are met. With a Roth IRA, you can withdraw contributions anytime tax- and penalty-free because the rules assume the first money out represents your after-tax contributions. With the 401(k), though, before the age 59½ and five-year tests are satisfied, the withdrawals are treated as a mixture of tax-free contributions and taxable earnings. Assume you contribute $20,000 a year for four years and your account has grown to a total of $90,000. Under the pro-rata rule, because $10,000 of earnings represents 11% of the balance, 11% of a withdrawal would be taxed; the other 89% would be tax-free. If you're younger than 59½, tack on a 10% early-withdrawal penalty.

The Rollover Solution

It has been widely reported that you can avoid these issues by rolling Roth 401(k) money to a Roth IRA. But it's not quite that simple.

A rollover will avoid the need for RMDs. And, once the money is in the IRA, you'll be able to withdraw your contributions tax-free without having to worry about the ratio of contributions to earnings. But things can be more complicated when it comes to earnings—both before and after the rollover. That's because the length of time you had a Roth 401(k) does not count toward the five-year test for a Roth IRA.

If you have owned any Roth IRA before the rollover, the time you've owned it counts for the rollover Roth IRA. But if the rollover IRA is your first Roth, the clock starts from zero for purposes of making the earnings tax-free.

What about the earnings inside the Roth 401(k) that are rolled into the Roth IRA? Well, it depends. If your 401(k) meets the five-year test and you're at least 59½ at the time of the rollover, earnings that were in the 401(k) are treated the same as contributions and can be withdrawn tax- and penalty-free. Only earnings in the Roth IRA after the rollover are subject to the five-year rule.

But if your Roth 401(k) didn't pass both tests before the rollover, only the contribution part of the rollover can be tapped tax- and penalty-free until your rollover Roth IRA meets the five-year test and you're 59½ or older. **K RACHEL L. SHEEDY**

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