Employee After-Tax Contributions

Frequently Asked Questions

Employee after-tax contributions have been a feature available to retirement plans for decades, but recently have grown in popularity. Whether you are new to voluntary after-tax contributions or you have been making them for years, you probably have questions about what they are and how they work. Below are answers to some of the most frequently asked questions.

Are Voluntary Employee After-Tax Contributions Available in All Retirement Plans?

No. Like loans, hardship distributions, and Roth accounts, the ability to contribute voluntary employee after-tax contributions is completely at the discretion of the employer.

What's the Difference Between Voluntary After-Tax Contributions and Roth Contributions in a Retirement Plan?

Some retirement plans provide the opportunity for employees to defer some of their salary on an after-tax basis in addition to traditional and Roth salary deferrals. Both voluntary (non-Roth) after-tax contributions and designated Roth contributions are deducted from salary after taxes. Designated Roth contributions are subject to the annual salary deferral limit and when combined with other pre- tax salary deferrals cannot exceed $23,000 (in 2024), plus a catch-up contribution for those age 50 and older which is $7,500. Voluntary after-tax (non-Roth) employee contributions are not subject to this limit. Instead, when combined with all sources of contributions, employee and employer, they are limited by the annual defined contribution limit of

$69,000 in 2024. For example, if you intend to max out your traditional pre-tax deferrals in 2024 at $23,000 and your employer makes a $6,000 matching contribution, that would allow you to make up to $40,000 in voluntary employee after-tax contributions to your retirement plan ($69,000 - $23,000 - $6,000 = $40,000).

Can After-Tax Accounts in a Retirement Plan Be Rolled to an IRA After and Employee Retires or Separates from Service?

Yes. But how they are rolled over and to what type of IRA (traditional or Roth) will impact taxation of the rollover and the subsequent taxation of the dollars when they are distributed from the IRA.

What are the Tax Consequences if the After-Tax Dollars are Rolled Over to a Traditional IRA in a Lump Sum Distribution?

After-tax contributions rolled in a tax-free rollover to a traditional IRA as part of a lump sum distribution should be reported to the IRS on Form 8606 when filing your tax return for the year. The after-tax amount ("basis") should be tracked so when subsequent distributions are made from the traditional IRA, those dollars are not taxed again on the way out. Traditional IRAs that contain a combination of pre- and post-tax dollars use a pro-rata rule to determine the amount that is taxable when an IRA distribution is taken. This pro-rata rule applies regardless of whether the after-tax amounts are held in the same or in a separate IRA.

What are the Tax Consequences if the After-Tax Dollars are Rolled Over to a Roth IRA in a Lump Sum Distribution?

After-tax contributions can be rolled tax-free to a Roth IRA in a direct rollover. However, earnings on the after-tax contributions are considered pre-tax amounts and if rolled to the Roth IRA in a lump sum distribution would be considered a taxable conversion. The rollover into the Roth IRA starts the 5-year holding period unless the Roth IRA had received other contributions prior to the rollover. Subsequent distributions from the Roth IRA would be subject to normal Roth IRA ordering rules and will be either qualified (tax-free) or non-qualified (earnings subject to income tax and possibly a 10% early withdrawal penalty). The rollover of after-tax contributions would be withdrawn first before any earnings are distributed under Roth IRA ordering rules.

Can a Lump Sum Distribution with After-Tax Dollars Be Split Between a Traditional and Roth IRA?

Yes. At the time of the distribution, you can instruct the plan administrator to divide the lump sum distribution between a traditional and Roth IRA before the direct rollover is made. The after- tax dollars could be directed in a tax-free rollover to the Roth IRA, while all remaining pre-tax balances, including earnings on the after-tax contributions, could be directed in a tax-free rollover to a traditional IRA. For individuals who have maxed out their salary deferrals and have additional discretionary income to save, contributing on a voluntary after-tax basis is a way to strategically build up balances that can later roll into a Roth IRA. This strategy has been sometimes referred to as a Mega Roth, Super Roth or Mega Back-Door Roth IRA funding strategy.

Can I Take a Tax-Free Distribution of Only the After-Tax Contributions in the Retirement Plan and Leave the Rest of the Money in the 401(k)?

Generally, no. If balances remain in the plan, you are taking a partial distribution. Partial distributions are taxed and distributed differently than lump sum

distributions. Partial distributions are subject to a pro-rata rule. A partial distribution, when paid to the participant would consist of a portion of each of the accounts in the plan. You cannot selectively distribute the after-tax contributions unless the special pre-1987 rule applies. Pre-1987 voluntary after-tax contributions can be distributed without being subject to the pro- rata rule discussed above. Plan administrators must account for pre-1987 and post-1986 dollars separately.

Can I Roll Over Only the After-Tax Dollars in the Plan to a Roth IRA and Leave the Rest of the Money in the 401(k)

Generally, no. Partial distributions are distributed on a pro-rata basis. Therefore, the rollover would represent pre-tax account balances (pre-tax salary deferrals or employer contributions) and not just the after-tax contributions themselves. A special rule applies for pre-1987 after-tax contributions which can be distributed separately in a partial distribution.

Are After-Tax Balances in a Retirement Plan Subject to Required Minimum Distributions (RMDs)?

Yes, if you are required to take minimum distributions from your employer's retirement plan and the plan has after-tax account balances, those amounts will be included when calculating the RMD amount. After-tax balances that are rolled over to a Roth IRA would not be subject to RMDs.

Take the Next Steps

If you have been looking for more ways to save for retirement and your employer offers voluntary (non-Roth) after-tax contributions, you may want to consider taking advantage of them. If you aren't sure if your plan allows you to make voluntary after-tax contributions, check with your plan's administrator.

You also may want to consider visiting with your tax and financial advisors to discuss a plan for your retirement savings' future. Your financial advisor can help you review the alternatives that your employer provides. ■

IMPORTANT DISCLOSURES The information provided is based on internal and external sources that are considered reliable; however, the accuracy of this information is not guaranteed. This piece is intended to provide accurate information regarding the subject matter discussed. It is made available with the understanding that Benjamin F. Edwards is not engaged in rendering legal, accounting or tax preparation services. Specific questions on taxes or legal matters as they relate to your individual situation should be directed to your tax or legal professional. In providing this information to you, neither Benjamin F. Edwards nor our financial advisor, is acting as a "fiduciary" under the Employee Retirement Income Security Act of 1974 (ERISA) and it should not be considered individualized investment advice or an investment recommendation.