

Making after-tax 401(k) contributions

Tax laws and rules can change from year to year. That's why having a pool of retirement income with low to no related tax liability could represent a prudent tax diversification strategy. Making employee after-tax contributions to a 401(k) plan is one way to potentially build a source of retirement income with little tax impact.

What are after-tax accounts?

After-tax accounts within a 401(k) or similar workplace retirement plan hold employee after-tax contributions and attributable earnings on such amounts, if any. After-tax contributions are amounts other than designated Roth contributions that a plan participant elects to set aside from his or her paycheck after the payroll department withholds taxes. Compare them with pretax employee salary deferrals, where the employee sets aside a portion of pay before taxes have been removed. The first employer-plan-based after-tax contributions were made to profit-sharing or money-purchase pension-style thrift plans in the late 1950s. The after-tax contributions were generally discretionary, if they were being made to profit-sharing plans, but could have been mandatory in the case of money purchase pension plans. As a result of the tax advantages introduced in the Revenue Act of 1978, which included a provision that allowed for the creation of 401(k) plans and the ability to make pretax salary deferrals, traditional thrift plans have all but disappeared. Yet about 25% of today's 401(k) plans still offer participants the ability to make employee after-tax contributions other than designated Roth contributions.¹

Contributions

Depending on the terms of the retirement plan, after-tax contributions may be accounted for separately or commingled with other non-Roth assets. The after-tax conversion strategy can only work when the plan accounts for after-tax contributions separately. If the plan accounts for after-tax contributions separately, any gains or losses in the after-tax account are tracked separately from the gains and losses associated with the participant's other accounts (e.g., salary deferral, matching, rollover, etc.). There are limits to the amount of after-tax contributions a participant can make in a 401(k) plan. The law requires plan administrators to consider all after-tax contributions, along with employee salary deferrals and employer contributions, when determining a participant's annual maximum contribution or annual additions limit under IRC Section 415(c). These rules currently limit a participant's annual additions for 2025 to 100% of compensation up to \$70,000/year (\$77,500 with catch-up at age 50 or older and a new age 60-63 catch up amount of \$11,250 making the total allowance \$81,250 for age 60-63) for 2025. A participant's after-tax contributions are also included in the actual contribution percentage (ACP) test for the plan, which requires that matching and after-tax contributions in a 401(k) plan do not unduly favor highly compensated employees (HCEs) over non-HCEs. Finally, after-tax contributions are considered in the top-heavy test for the plan. If a plan is top-heavy, meaning more than 60% of its assets are held by key employees (generally, the owners and officers of the business), then the plan must include vesting guidelines and meet certain minimum contribution requirements for the non-key employees. Even a safe harbor design does not eliminate these testing requirements for after-tax accounts.

Distributions

Initially, participants could withdraw their employee after-tax contributions tax-free before retirement (i.e., before the benefit became payable as an annuity). Lawmakers became concerned that workers were using these tax-favored arrangements for nonretirement savings purposes. The Tax Reform Act of 1986 implemented revised basis recovery rules that apply to an after-tax account, generally applicable to distributions taken after December 31, 1986, that provide for the pro rata recovery of basis and earnings for preretirement payments.

¹ Plan Sponsor Council of America, 66th Annual Survey, 2023; Retirement Learning Center plan document database, 2024.

Under these rules, the amount a participant is entitled to exclude from taxation is determined by multiplying the amount of the payment by the ratio of the participant’s basis to the total value of the participant’s account balance under the plan as of the date of distribution. A special grandfather rule allows participants to first withdraw their pre-1987 after-tax contributions that have been tracked separately on a completely tax-free basis.²

Calculating the tax-free amount

Amount distributed

x

After-tax contributions³

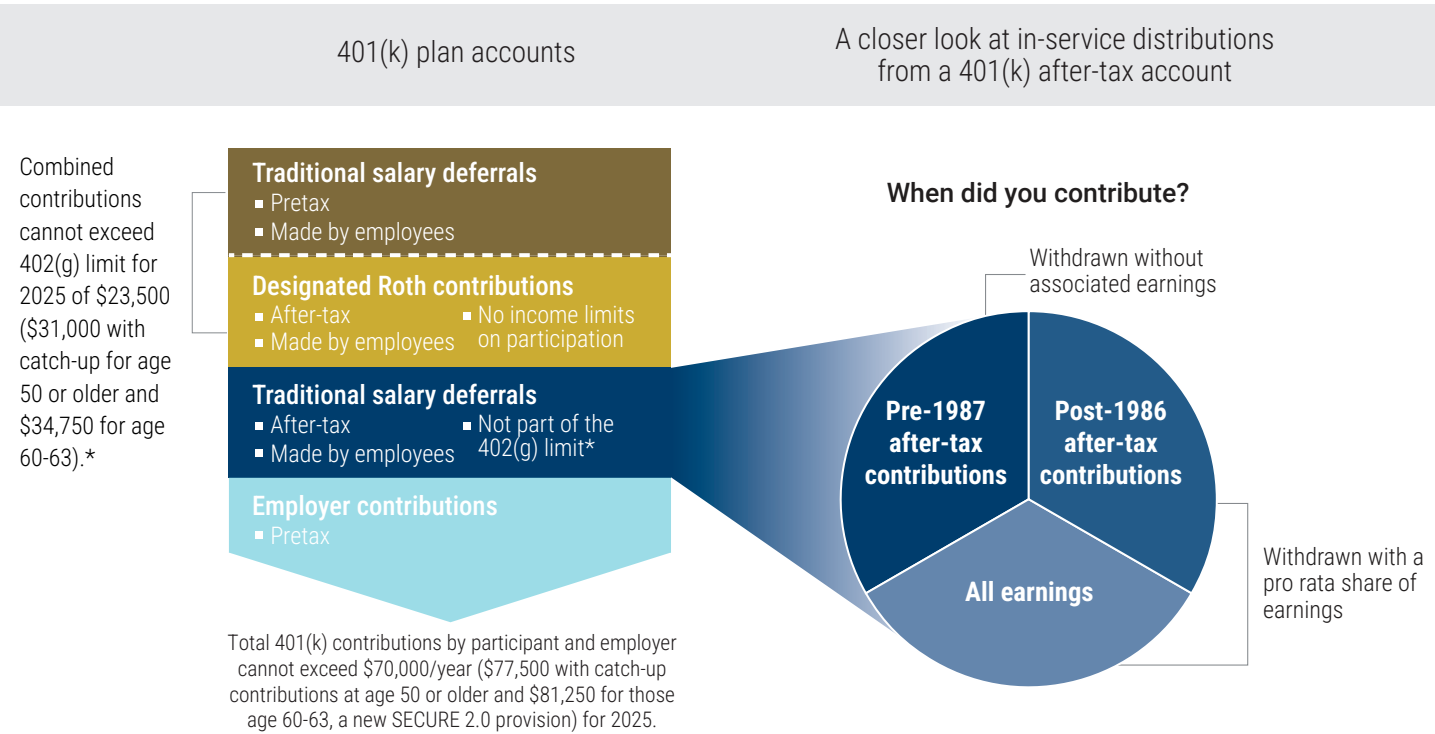
After-tax account balance⁴

=

Tax-free amount

If the 401(k) plan has not tracked the pre-1987 and post-1986 after-tax amounts separately but has tracked the after-tax contributions separately, the basis recovery rules apply to the entire after-tax account.

In-service withdrawal of 401(k) after-tax account



Portability options

If the plan document permits, a plan participant may request a distribution of 401(k) plan after-tax contributions while still working. As explained previously, the tax consequences typically depend on whether the distribution comes from pre-1987 or post-1986 after-tax amounts and what the participant chooses to do with the distribution. Prior to 2002, employee after-tax contributions in 401(k) plans lacked portability. They were not eligible for rollover to another plan or to an IRA. The Economic Growth and Tax Relief Reconciliation Act of 2001 changed that by allowing employee after-tax contributions to be included in an eligible rollover distribution, provided the receiving plan is an IRA or a defined contribution plan that separately accounts for the amount.

Therefore, if a plan participant chooses not to leave the after-tax account in the plan, he or she has the following portability options: 1) roll over the assets to a new employer's plan, if permitted; 2) roll over the assets to a traditional IRA; 3) convert the assets in-plan to a designated Roth account or out-of-plan to a Roth IRA; or 4) cash out the account. Each choice offers advantages and disadvantages, and the optimal choice is a question of suitability for the investor. A distribution decision should only be made after reviewing information that is fair, balanced and not misleading. Investors should consider several factors, including, but not limited to, available investment options, fees and expenses, services, penalties, creditor protection, required minimum distributions (RMDs) and the tax treatment of employer stock.

Rollovers to traditional IRAs or qualified retirement plans

Plan participants can roll distributions of their after-tax accounts to either a traditional IRA or a qualified retirement plan. If a rollover to an IRA is selected, it can be accomplished directly, where the distribution goes immediately to the receiving IRA, or indirectly, where the participant receives a distribution and rolls over all or a portion of it within 60 days. The IRS views the amount rolled over indirectly as consisting first of pretax amounts, followed by after-tax amounts. If a participant selects a rollover of his or her after-tax account to a qualified retirement plan, it must be accomplished as a direct rollover.

Roth IRA conversions

Tax law changes and clarifications effective in 2002, 2008, 2010 and 2014 combined to create a new option for affluent investors looking for ways to acquire Roth assets in a tax-efficient manner. The 2002 changes introduced portability options for employee after-tax contributions. The 2008 changes gave qualifying plan participants the ability to convert all or a portion of their 401(k) plan balances directly to Roth IRAs, provided they experience a distribution trigger under the terms of the plan (such as having an in-service distribution option or severance of employment). And the 2010 changes eliminated the income restrictions on Roth conversions. Consequently, an investor's after-tax account in a 401(k) plan may offer a potentially tax-efficient way to convert contributions and earnings to a Roth IRA if there is a favorable after-tax contribution-to-earnings ratio. Finally, in 2014, IRS Notice 2014-54 cleared the way to make tax-free Roth conversions. In the last year, Congress has considered eliminating the ability to convert after-tax IRA and plan assets to Roth IRA assets.

Over 80% of all 401(k) plans today offer in-service distributions, which allow participants to withdraw amounts from their plan while they are still working.⁵ Of the plans that offer in-service distributions, many participants may request a distribution of their after-tax account balance at any time. When contemplating a Roth IRA conversion — a type of rollover — participants should consider the pros and cons of their distribution options (i.e., leave the assets in the plan, distribute them or roll them over to another employer's plan or IRA). Considerations for each include fees and expenses, levels of service, investment options, penalty-free withdrawals, creditor protection, RMDs and employer stock. Participants must consider any surrender charges or penalties that may result from the conversion.

Roth IRAs can offer tax diversification benefits at retirement and legacy planning advantages over traditional IRAs. Investors may want to consider a Roth IRA conversion of their 401(k) after-tax account if they:

- Are currently ineligible to contribute to a Roth IRA because of their income level.
- Contributed after-tax contributions to their workplace retirement plans before 1987.
- Have the ability to contribute to their 401(k) plans on an after-tax basis but have not yet done so.

⁵ Plan Sponsor Council of America, 66th Annual Survey, 2023; Retirement Learning Center plan document database, 2024.

- Have an in-service distribution option in their plans.
- Would like to avoid mandatory distributions during their lifetimes with Roth IRAs.
- Would like to accumulate potentially tax-free assets for their beneficiaries.⁶

In the past, a conversion to a Roth IRA that included pretax dollars was a taxable event. A participant included — as ordinary income in the year of the conversion — the amount of any pretax dollars he or she converted to a Roth IRA. The pretax amounts were taxable at the participant’s current tax rate. However with the IRS guidance in Notice 2014-54, it is possible to accomplish a tax-free Roth IRA conversion. The basis recovery rules that apply to after-tax accounts (covered previously) remain applicable, but Notice 2014-54 allows plan participants to direct the distributing plan administrator to send the pretax portion of the distribution to a traditional IRA (resulting in a tax-free rollover) and the after-tax portion of the distribution to a Roth IRA (resulting in a tax-free conversion).

Example: Tax-free Roth IRA conversion

Sue, who works for Slim Solutions, LLC, wants to convert her after-tax account in her 401(k) because she learned the plan allows for in-service distributions, and she has concluded a conversion to a Roth IRA makes sense for her long-range financial goals. Her 401(k) plan account statement reads as follows:

Pre-1987 after-tax	\$20,000
Post-1986 after-tax	\$30,000 (includes \$5,000 earnings)
Employer matching	\$50,000
Profit sharing	\$50,000
Salary deferrals	\$50,000
Total	\$200,000

In the example above, Sue’s total amount in her after-tax account, which has been separately tracked, is \$50,000. Sue wants to convert and roll over \$50,000 to a Roth and traditional IRA in the most tax-efficient way possible. Sue requests a distribution of her after-tax account (\$50,000). Following Notice 2014-54, she informs the

plan administrator to directly roll over the pretax amount (\$5,000 of earnings) to her traditional IRA and the after-tax amount (\$45,000 of contributions) to a Roth IRA. The result is a \$5,000 tax-free traditional IRA rollover and a \$45,000 tax-free Roth IRA conversion. The key is to direct the plan administrator to distribute the assets to multiple destinations. If Sue were to convert the entire amount to a Roth IRA alone, she would have to include the \$5,000 of earnings in her taxable income for the year. In this scenario, Sue would need to file IRS Form 8606 to account for the \$45,000 conversion to her Roth IRA.

As an alternative to the previous direct rollover scenario, a participant could consider an indirect or 60-day rollover. Under this approach, an eligible plan participant takes a lump-sum distribution of his or her after-tax account, subject to standard 20% federal withholding rules. Within 60 days, he or she rolls over the pretax amount (the earnings) into a traditional IRA and subsequently rolls over the after-tax amount to a Roth IRA, provided it is still within the 60-day rollover time limit. Of course, by using personal funds, the participant would also have to roll over the amount withheld for federal income tax purposes (20% of the pretax amount) to avoid including that amount in taxable income.

In-plan Roth conversion

The amount that a plan participant can contribute annually as a designated Roth contribution is limited.⁷ Similar to jump-starting a Roth IRA with a no-tax-impact after-tax account conversion, eligible 401(k) plan participants could consider jump-starting or front-loading their designated Roth accounts through in-plan conversions, if available. Plan document language will specify whether this is an option.

In-plan conversions must be completed as a direct rollover within the plan to a designated Roth account. Participants who complete in-plan conversions must include the taxable portion of their conversions in income for the year under the standard conversion taxation rules. Because of the pre-1987 grandfather/post-1986 basis recovery rules discussed previously, an in-plan conversion of a participant’s after-tax account to a designated Roth account is another tax-efficient way to acquire Roth assets.

⁶ This applies only if the original owner or the owner and beneficiary together have held the Roth for at least five years.
⁷ For 2025 the combined total of pretax salary deferrals and qualified Roth contributions cannot exceed \$23,500 for participants under age 50, \$31,000 for those age 50 or older and \$34,750 for those ages 60-63.

Moving ahead with after-tax contributions

If a plan participant, working with a tax advisor, is considering a 401(k) after-tax contribution strategy, the first hurdle is to determine whether the participant's plan allows for these contributions and tracks them separately. To know whether a participant has an after-tax contribution option in the 401(k) plan, he or she can check with the benefits administrator or review the plan document or summary plan description for the plan. If the participant discovers that an after-tax option exists and is tracked separately, he or she should consider several key questions:

- Should the participant contribute to the plan on an after-tax basis, and if so, how much?
- Does the plan allow for an in-service distribution of the after-tax account balance?
- Should the participant consider a withdrawal, rollover or conversion of the after-tax account balance?
- What would the tax implications be in each scenario?

These are important questions, and ideally, a participant should not go it alone. He or she should rely on a team of tax and financial professionals to offer insight and guidance.



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