Roth IRA distributions are different from employer Roth distributions (Roth 401(k), Roth 403(b), or Roth 457).

A Roth distribution is a qualified distribution if the withdrawal passes **both** of two tests: the time test and the purpose test. The time test is the owner having a Roth IRA somewhere for at least five Roth years. All Roth years end on Dec 31. The next Roth year starts on Jan 1. There are only 4 qualified purposes which would pass the purpose test. You can use the phrase "**Denver Area Fire Department**" to remember the ROTH IRA qualified distribution purposes.

Denver – D – Death
Area – Age – Age 59 ½
Fire – F – First Time home buyer expenses up to $10,000 of taxable distributions
Dept – D – Disability (Social Security definition of disability

These four reasons for a qualified distribution are also exceptions to the 10% early withdrawal penalty (EWP). However, not every exception to the 10% EWP are part of the purpose test. Note that higher education costs do not make the list. That is why the Denver Area Fire Department is not a bunch of PhD's.

Employer Roth qualified distributions are even easier. Think "DAD:"

D – Death
A – Age 59 ½
D – Disability (Social Security definition of disability

NOTE: Age 59 ½ is only one reason for a qualified Roth distribution. You CAN have a qualified distribution earlier than 59 ½. However, practically, for most people, 59 ½ would be their first opportunity because they didn't die or get disabled before 59 ½. Also, if they are already buying a home and don't move, they can't have first-time homebuyer expenses. Technically, they can later become a first-time home buyer if they don't own a home for two years, but still…

Non-Qualified Roth Distributions

The right place to start for withdrawals that are not qualified distributions is the "bucket brigade." Start all non-qualified Roth distributions by categorizing the Roth IRA into three buckets.

Bucket 1: Contributions. The first money withdrawn from a Roth IRA is ALWAYS AND WITHOUT EXCEPTION contributions. Contribution money was not deductible so contribution money cannot be income taxed. Also, since contribution money was not income taxed, it cannot be subject to the 10% EWP rules. In other words, withdrawn contributions are always income tax and early withdrawal penalty free no matter what. For example, my daughter was a famous baby model. Her earned income allowed us to set up a Roth IRA for her. By the time she was 7, we had contributed $30,000 into her Roth IRA. As a glamorous model, she became spoiled. She withdrew $25,000 to buy a collector's edition Malibu Barbie beach house (with a matching

corvette). She was not income taxed on the withdrawal even though she was only 7. Nor was she 10% penalized. After the withdrawal, she had $5,000 in the contribution bucket. Remember, contribution withdrawals are accounted as coming out first and they can never be taxed or penalized.

Bucket 2: Conversions. After the contribution bucket is totally empty, the next money withdrawn is accounted for as coming from the oldest conversion. Since conversions of formerly deductible retirement accounts were income taxed at the conversion, the withdrawal of conversion money is **never subject to income tax** because income taxing the withdrawal would mean that money would be income taxed twice. (The first time would be when the money was converted into the Roth IRA. The second time would be at the withdrawal.)

Usually when something is not income taxed it is not penalized. However, **to protect against sham conversions, withdrawals of converted money are subject to the 10% EWP rules for five years**. After 5 years, the conversion money becomes like contribution money even though it stays in the conversion bucket. Withdrawing this 5-year old or longer money is neither taxed nor subject to the 10% EWP system. During the five years, however, a withdrawal of converted money is subject to the 10% EWP. However, being subject to the 10% EWP rules does not mean the withdrawal will end up paying the 10% EWP. For example, if you pull the conversion money out within 5 years of the conversion to buy a bass boat at age 50, you are 10% penalized even though you don't owe income taxes. If you pull the same money out within five years of the conversion to pay for your daughter's college tuition and you are not 10% penalized because you met an exception.

Bucket 3: Earnings. This is when asking if a distribution is a qualified distribution really counts. Earnings are always subject to income tax and the 10% early withdrawal (unless they are part of a qualified distribution. Of course once the owner reaches age 59 ½ the 10% penalty goes away.

Finally, a word about spouses inheriting a Roth IRA. Spouses who inherit a Roth IRA have the same two choices a spouse inheriting a traditional IRA: leave the account as an inherited IRA or move the money into their own name. An inherited IRA is titled in the deceased name. For example, “Thomas B Harris III (deceased July 28, 1987) FBO Erica L Harris.” Moving the money into the spouse’s own name means the account would have already existed or the title of the new account would simply be “Erica L Harris.”

If the surviving spouse is under 59 ½, it is probably far better to leave the money as an inherited account. First, any withdrawals after five Roth years from the establishment of the account by the now deceased person are qualified distributions for any reason because the withdrawals from an inherited account are treated as being made due to a death. If the money was moved into the surviving spouse’s own name, this advantage is lost. That could be a big deal. Why pay income tax on the earnings and also a 10% EWP when money is taken from the surviving spouse’s own Roth IRA, when leaving the money in the inherited Roth IRA would have always been tax and penalty free?

If the surviving spouse is age 59 ½ or older and has already satisfied the five year rule for their own Roth IRA, then consolidating into that account is probably preferred as a matter of convenience.

By the way, our daughter's collector's edition Malibu beach house would have been worth $3 million today if it was in mint condition, but she took it out of the package and played with it once so it is only worth $10. We lost the corvette.

Employer Roth Distributions

There are three types of Employer Roth accounts: Roth 401(k), Roth 403(b); and Roth 457(b) plans. Withdrawals from these accounts are income taxed differently from Roth IRAs. First, the test for a qualified distribution does not include up to $10,000 for a qualified first-time homebuyer. Second, each employer Roth account sort of has its own five year holding period. It is "sort of" has its own five year holding period because:

1. Contributing to a new employer Roth account starts the five year holding period for that employer's Roth account only. That is different from a Roth IRA. Each person's Roth IRAs all started their five year period when the individual opened their first Roth IRA. For example, Joe started a Roth IRA with the ABC Fund Family on March 27, 2017, but it was coded for 2016.Thus, Joe started all his Roth IRAs on Jan 1, 2016. When he opened a new Roth IRA in 2025 with the XYZ Funds, that XYZ Roth IRA is counted as having started on Jan 1, 2016 for the five year rule.

    However, if Joe started a Roth 401(k) with Company 1 on March 27, 2017, that Roth 401(k) started on Jan 1, 2017. If he moved to Company 2 and started contributing to the Company 2 Roth 401(k) on July 1, 2020, then his five years for the Company 2 Roth 401(k) on Jan 1, 2020.

2. If he moved his Company 1 Roth 401(k) into his Company 2 Roth 401(k), then the starting point for the five years comes with it. Thus, that money has a Jan 1, 2016 start date. This is the law, but practically, it is important to insure that the proper documentation comes from Company 1 and is received by Company 2.

3. There is are two extremely important advantages in rolling money from an ex-employer's Roth account into a Roth IRA if money might be withdrawn prior to age 59 ½. First, withdrawals from a Roth IRA are accounted for as contributions first, then conversions then earnings. Withdrawals from an employer Roth are accounted for as coming out ratably. For example:

    Tina, age 45, has $10,000 in her Roth IRA and another $10,000 in her Roth 401(k). Both accounts have $6,000 in contributions and $4,000 in earnings. Tina has separated from serviceand is looking for a new job. She needs $5,000 for living expenses.

    a. Withdrawing $5,000 from her Roth IRA would be income tax and penalty free. After the withdrawal, her Roth IRA would have $1,000 in the contributions bucket and $4,000 in the earnings bucket.

b. Withdrawing $5,000 from her Roth 401(k) would mean 60% would be a contribution and 40% would be earnings. Thus, she would be income taxed and 10% penalized on $2,000. After the withdrawal, her Roth 401(k) would still be 60% contributions and 40% earnings.

This example shows a small income tax and 10% EWP bill. However, what if the accounts and the withdrawals were higher? Second, being out of work is stressful. Losing money to taxes feels especially impactful during stressful time. Third, clients remember advisors who help them during difficult times. They also remember those who did not.

Second, there is much less administrative risk moving employer Roth money to a Roth IRA. In the real world there is a chance one employer or the other will have a record keeping problem.

Thus, it is generally preferable to move employer Roth money to an IRA upon separation from service because nonqualified distributions are more favorably taxed.

4. What are the advantages of transferring money from one employer Roth to another?

a. Employer retirement accounts are more favorably treated for asset protection purposes than IRAs. 100% of employer retirement accounts have asset protection. Until 2022, only the first $1,362,800 of an IRA is asset protected. That number is inflation adjusted every 3 years. The next time will be 2022. Since most retirement accounts are well below $1 million this seems like a minor point.

b. The new employer plan might allow loans. No IRA account, including SEPs and SIMPLE IRAs can ever allow loans.