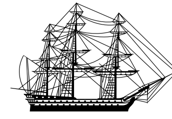

SRC Tax Bulletin: Clarifying the rules on distributions from qualified plans

In September 2014, the Internal Revenue Service (IRS) released Notice 2014-54, which clarifies the rules for qualified plan distributions of pre-tax and after-tax amounts to multiple destinations. A brief question-and-answer supplement was published in the IRS's December 23, 2014 edition of Employee Plans News. For purposes of this guidance, qualified plans include 401(a) and 401(k) plans, 403(b) plans, or 457(b) plans maintained by certain governmental employers.

Background

In 2009, the IRS issued an updated model 402(f) Special Tax Notice. This notice appeared to require that if a participant took a distribution of pre-tax and after-tax amounts and elected to have the distribution sent to more than one destination, each payment would be treated as a separate distribution and would include a pro-rata portion of pre-tax and after-tax amounts. This interpretation of the rollover rules had been inconsistent with industry practice. Also, it became unclear whether a pre-tax and after-tax distribution sent to multiple destinations required a single step or a series of steps.

Notice 2014-54

The September 2014 notice clarified that participant distributions from qualified plans made at the same time are treated as a "single distribution" regardless of whether the participant chooses a single destination or multiple destinations. Furthermore, if the participant elects multiple destinations, each portion of the distribution doesn't need a pro-rata allocation of pre- and after-tax amounts. Accordingly, participants requesting a distribution containing both pre-tax and after-tax amounts can roll over the pre-tax amount (including earnings on the after-tax amounts) to a traditional IRA and the after-tax basis to a Roth IRA.

The new guidance is effective for distributions made on or after January 1, 2015.

What this means to participants

By allowing participants to allocate the pre-tax and after-tax portions of a distribution to multiple destinations, the guidance provides participants with more flexibility in tax planning and is of particular interest to those who have made after-tax contributions to their plan. Participants eligible for distributions may elect to roll their after-tax assets from the plan to a Roth IRA and pre-tax money (including earnings on after-tax contributions) to a traditional/rollover IRA. This essentially allows participants to move after-tax assets from a tax-deferred account in the plan to a Roth IRA account where future earnings and distributions will be tax free—assuming the conditions for qualification are met—with no tax consequences at the time of the transaction.[1]

Examples

One example of this practice would be a participant who terminates employment and has a total balance of $100,000 in his 401(k) plan account, $20,000 of which is after-tax. The notice clarified that it's possible to send the $80,000 of pre-tax money to a traditional/rollover IRA (or another qualified plan), and the $20,000 after-tax portion directly to a Roth IRA (or retained by the participant), assuming the participant notifies the 401(k) plan administrator of his intentions so that the distributions can be reported appropriately.

To the extent retired or terminated participants take out only a portion of their accounts, the pro-rata rules under IRC Section 72(e)(8) would still apply to determine how much is coming out of each source. Using the same example, where the 401(k) balance is $100,000, with

1 Under current law, a qualified distribution is one that's paid as the result of death, disability, or reaching age 59½, and occurs no earlier than five years after the first day of the calendar year in which the first designated Roth contribution was made.

$20,000 in after-tax, and the individual is only requesting a $20,000 distribution, then the distribution is treated as $16,000 of pre-tax and $4,000 of after-tax. If the account owner wants to place the entire $20,000 of after-tax into a Roth IRA, he will be required to take a distribution of the entire $100,000 from the 401(k) plan.

If a plan allows for in-service withdrawal of after-tax money, under the Tax Reform Act of 1986, any withdrawal of after-tax assets contributed post-1986 must have a proportionate amount of earnings attached to the distribution. Note that after-tax contributions made prior to 1987 have no such requirement.

Plan sponsor considerations

While some plan sponsors may choose to add after-tax contributions as a result of this notice, careful consideration should be given prior to the addition of a new after-tax contribution feature, because of factors such as additional nondiscrimination testing requirements associated with after-tax contributions, and the availability of the more "tax-efficient" Roth 401(k) option. Currently only one in five Vanguard full-service recordkeeping plans offers after-tax contributions and only 8% of participants in those plans make after-tax contributions (*How America Saves*, 2014).

For plans currently offering after-tax contributions, or that have significant legacy after-tax dollars, this guidance may provide participants with the ability to maximize planning opportunities related to rollovers. But there are potential downsides for participants who roll money out of the qualified plan. For example, participants under age 55 would lose the ability to avoid the early withdrawal penalty on 401(k) plan distributions when separating from service after age 55 (but before age 59½), or lose the opportunity to take advantage of net unrealized appreciation rules for company stock. Though these scenarios may not be common, they have significant potential impact for those who are eligible, and should at least be coordinated with the overall Roth conversion strategy.

Conclusion

The IRS has provided clarification on the rules governing after-tax rollovers from a 401(k) plan to a Roth IRA, providing taxpayers great flexibility in managing rollovers. Please contact your relationship manager if you have questions or comments concerning the material discussed in this bulletin.

There are important factors to consider when rolling over assets to an IRA. These factors include, but are not limited to, investment options in each type of account, fees and expenses, available services, potential withdrawal penalties, protection from creditors and legal judgements, required minimum distributions, and tax consequences of rolling over employer stock to an IRA.

All investments are subject to risk, including the possible loss of the money you invest.

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