IRS: New Mechanism to Split Pre- & After-tax Assets in a Rollover

Last week, in Notice 2014-54, the Internal Revenue Service (IRS) unveiled proposed regulations that outline rules on how to allocate distributions from retirement plan accounts which contain both pretax and after-tax contributions. These regulations cover 401(k), 403(b), and 457 plans. **In essence, this new guidance offers a mechanism for splitting of pretax and after-tax assets via a direct rollover.** The new development is a recognition by the Service of a practice already in place at some financial institutions where withdrawals from retirement plans that contain both pretax and after-tax contributions are *even now treated as a single distribution rather than as separate distributions* under the old rule.

The Old Rule

Previously, an individual could *not* split the pre-tax and after-tax amounts in a direct rollover. Instead, it had to be done exclusively through an indirect aka 60-day rollover. First, plan participant would receive a cash distribution, then indirectly roll over the pre-tax amount to another retirement plan or an IRA. The remaining after-tax amount could then be moved to a Roth IRA or an after-tax account. The practical difficulty of that approach had to do with the 20% mandatory federal income tax withholding applicable to any pre-tax amounts directly distributed to the participant. An individual had to make up the 20% withheld by his employer when re-depositing the pre-tax amount to avoid income tax and to successfully deposit the remaining after-tax amount to a Roth IRA.

The New Rule

Under the new rule, all distributions from a plan scheduled at the same are treated as a single disbursement regardless of whether they go to a single or multiple accounts. The new rule makes it possible to split the pre-tax amounts and after-tax amounts via a direct rollover.

The Details

- If a pretax amount of combined disbursements treated as a single distribution under the new rule is less that the amount of the direct rollover, the entire pretax amount is allocated to the direct rollover. If the rollover is to more than one plan, then the individual can select how the pre-tax amount is to be allocated among these plans by communicating that election to plan administrator before the distribution takes place.

- If the pre-tax amount equals or exceeds the amount of direct rollover, then it is assigned to the portion of the distribution that's directly rolled over up to the amount of the direct rollover. Any remaining amount is then assigned to any indirect rollovers, aka 60-day rollovers.

- If the remaining amount is less than the 60-day rollover amount, then the individual can decide how the pre-tax amount is allocated between plans that receive the 60-day rollover.

- If after that assignment there is still remaining pre-tax amount, that amount becomes includible in the individual's gross income.

- If the amount rolled over to an eligible retirement account exceeds the portion of the pretax amount allocated to the plan, the excess is an after-tax amount.

Effective Date

The IRS stated that the new guidance will apply to distributions made **on or after January 15, 2015**. That said, the IRS also noted that tax payers are allowed to apply these proposed regulations to distributions made on or after September 18, 2014, the date the Notice was published.

Why It's Significant

This development opens wider doors for effective distribution planning. By eliminating the need to rely exclusively on indirect rollovers for splitting of pretax and after-tax amounts in plan distributions, often ridden with costly mistakes due to missed redeposit windows or inability to make up the 20% withholding, the IRS made planning for after-tax amounts in retirement plans more accessible.

Here's an example. A participant has a $150,000 account balance in her IRA: $125,000 is pre-tax and $25,000 are after-tax dollars. Upon retirement, she can elect to move $125,000 to a rollover IRA retaining the amount's tax-deferred status, distribute the remaining $25,000, and redeposit it to a Roth IRA as a tax-free conversion. Distributions from the rollover IRA will taxed at the time they are eventually withdrawn but the Roth IRA disbursements will be tax-free, provided they are qualified.

Retirement Services will continue monitoring further developments on the topic and update you as more information becomes available.

First Allied Retirement Services is available to consult with you concerning impact of acquisition on retirement plans which may already be in place or are contemplated in the future. We developed a variety of tools, reports, and materials to assist you in effective communication about these and other important retirement topics. The rules are complex and to succeed you need to either become an expert or align yourself with the right partner. We are available to be an extension of your team. Retirement Services consultants are ready to partner with you in presenting solutions to your clients and prospects. But we don't stop there; we help you implement and maintain the plan in partnership with nationally-recognized recordkeeping vendors to offer a complete plan solution. You can reach us at (888) 926-0600 or via email to pensions@firstallied.com .