IRS grants favorable tax options for certain plan distributions of pre- and after-tax amounts (Head)

Result: Some Roth IRA conversions may be fully tax free

Who says the IRS never cuts anyone a tax break. It just did in its September 19, 2014, Notice 2014-54, which changes the allocation rules for pre- and after-tax amounts of a distribution from a qualified retirement plan [under Internal Revenue Code Section (IRC §) 401(a)], as well as an IRC §403(b) and governmental IRC §457(b) plan that is sent to multiple locations. The special pre- and after-tax allocation rules of the notice generally apply to distributions made on or after January 1, 2015, although some taxpayers may apply the rules earlier in certain circumstances.

Prior to Notice 2014-54, if a plan distribution includes both pre- and after-tax amounts and was sent to multiple destinations, it would be reasonable for a plan administrator to treat each segment of the distribution as consisting of a pro rata share of pretax and after-tax amounts. Under Notice 2014-54, however, following an allocation hierarchy outlined in the notice, a distribution recipient is allowed to select how the pretax amount is allocated among the multiple destinations.

The notice defines an allocation hierarchy as follows:

1. The pre-tax amount of the distribution is first assigned to any direct rollovers elected by the participant.
2. If pre-tax dollars remain, they are next assigned to any 60-day rollovers elected by the participant. (Note: The distributing plan must apply 20% mandatory federal income tax withholding on 60-day or "indirect" rollovers)
3. Finally, if pre-tax dollars still remain after the direct and 60-day rollovers, the pre-tax amount is distributed to the participant and is includible in the recipient's taxable income.

The plan participant must inform the plan administrator of his or her pre-tax allocation scheme prior to the time of any direct rollovers. Notice 2014-54 offers several illustrations on the application of these special allocation rules. One example relates to a common scenario involving a Roth IRA conversion from a defined contribution plan.

EXAMPLE:

Cecil requests a $100,000 distribution from his 401(k) plan that consists of $80,000 of pre-tax amounts and $20,000 of after-tax amounts. Cecil informs the plan administrator that he would like to directly roll over $80,000 to a traditional IRA and $20,000 to a Roth IRA. Pursuant to Notice 2014-54, Cecil's direct rollover to the traditional IRA consists entirely of the $80,000 pre-tax amount and the direct rollover to the Roth IRA consists entirely of the $20,000 after-tax amount. The result is a tax-free Roth IRA conversion since only after-tax dollars were converted to the Roth IRA.

Absent the guidance of Notice 2014-54, it would be reasonable for the plan administrator to assign a pro rata share of pre-tax and after-tax amounts to the amount sent to the traditional IRA and likewise to the amount sent to the Roth IRA, resulting in a partially taxable Roth IRA conversion.

Similar rules are proposed to be effective for distributions from designated Roth accounts under just-released proposed Treasury regulations.

Conclusion

The full impact of the new guidance of Notice 2014-54 and proposed regulations will continue to unfold as further analysis is done. In the mean time, plan participants and their tax advisors should be made aware of the expanded tax options they now have with respect to allocating pre- and after-tax amounts of distributions sent to multiple destinations.