IRS Decides to Permit Separate Rollovers or Distributions of Pre-Tax Amounts and After-Tax Amounts From Defined Contribution Plans

Problem

Until recently, a participant in a defined contribution plan who was entitled to a lump sum distribution that included both pre-tax amounts and after-tax amounts (such as designated Roth deferrals) could not elect to directly rollover the pre-tax amount to a traditional IRA and the after-tax amount to a Roth IRA or to directly rollover the pre-tax amount and retain the after-tax amount.

Why?

Because IRS Notice 2009-68 and the relevant model I.R.C. 402(f) notice required that if a participant's eligible rollover distribution included both taxable and non-taxable amounts, the participant could not allocate the taxable amounts to a separate direct rollover from the non-taxable amounts because each distribution was deemed to include proportionate taxable and non-taxable amounts. The solution was that the participant could elect that a lump sum distribution which would be reduced by 20% for federal income taxes. Then within 60 days of receipt of the lump sum distribution, the participant could rollover the taxable portion of the distribution to a traditional IRA and either rollover the nontaxable portion of the distribution to a Roth IRA or retain the non-taxable amount. But this solution would only work if the participant had sufficient liquid assets outside of the plan to restore the 20% withheld for federal income taxes.

IRS Notice 2014-54 Solution

After five years of negotiations with representatives of defined contribution plan sponsors, the IRS has issued guidance permitting defined contribution plans to allow participants entitled to receive a lump sum payment of an eligible rollover distribution to elect to (1) directly rollover the pre-tax amounts (e.g., pre-tax elective deferrals, the earnings thereon, the earnings on traditional after-tax contribution and employer contribution amounts) to a traditional IRA or another employer plan and (2) separately rollover the after-tax amounts (e.g., Roth accounts and traditional after-tax contributions, but not the taxable earnings thereon) to a Roth IRA or, alternatively, to retain such after tax amounts.

Defined contribution plans affected by this new rule include 401(k) plans, 403(b) plans, 457(b) governmental plans and other defined contribution plans that permit both pre-tax and after-tax contributions.

IRC 402(f) Eligible Rollover Distribution Tax Notices Revised

On November 24, 2014, the IRS issued IRS Notice 2014-74, which includes two model forms of special tax notices that need to be sent to participants who are entitled to receive eligible rollover distributions. The first model tax notice is for participants whose benefit payment will be from pre-tax amounts only. The second model tax notice is for participants whose benefit payment is from after-tax amounts only. If a participant is entitled to receive benefit payments from both pre-tax amounts and after-tax amounts from a designated Roth account, it appears that both notices should be provided to the participant.

Here is a link to IRS Notice 2014-74.
http://www.irs.gov/pub/irs-drop/n-14-74.pdf

Action Items

Defined contribution plan sponsors and third party administrators need to be prepared to make separate rollovers and distributions in accordance with these new rules. Benefit payment election forms need to be revised. The model tax notices in IRS Notice 2014-74 need to be distributed or otherwise made available to participants entitled to receive eligible rollover distributions. The trustee or third party administrator who is responsible for a plan's IRS 1099-R reporting needs to provide and file a separate form for each separate distribution. Finally defined contribution plan sponsors may also need to amend the rollover and tax sections of a summary plan description if it includes a description of the old rules for proportionately taxable and non-taxable separate distributions.

Effective Date

The effective date of IRS Notice 2014-54 rules is January 1, 2015. However a participant entitled to receive an eligible rollover distribution on or after September 18, 2014, can elect to apply the new rules immediately.

Please let us know if you have any questions or if we can be of assistance.

Dated: December 1, 2014
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