

Guidance on Allocation of After-Tax Amounts to Rollovers

Notice 2014-54

I. PURPOSE

This notice provides rules for allocating pretax and after-tax amounts among disbursements that are made to multiple destinations from a qualified plan described in § 401(a) of the Internal Revenue Code. These rules also apply to disbursements from a § 403(b) plan or a § 457(b) plan maintained by a governmental employer described in § 457(e)(1)(A) (a “governmental § 457(b) plan”). Section VI of this notice provides transition rules.

II. BACKGROUND

Section 402(a) provides generally that any amount distributed from a trust described in § 401(a) that is exempt from tax under § 501(a) is taxable to the distributee under § 72 in the taxable year of the distributee in which distributed. Under § 403(b)(1), any amount distributed from a § 403(b) plan is also taxable to the distributee under § 72. (Under § 72(d), a different allocation method applies to annuity distributions.)

If a participant’s account balance in a plan qualified under § 401(a) or in a § 403(b) plan includes both after-tax and pretax amounts, then, under § 72(e)(8), each distribution from the account (other than a distribution that is paid as part of an annuity, which is subject to a different rule) will include a pro rata share of both after-tax and pretax amounts.

Under § 402A(d)(4), a designated Roth account in an applicable retirement plan is treated as a separate contract from other amounts in the plan when applying the rules of § 72.

Section 402(c) provides taxability rules for amounts that are rolled over from qualified trusts to eligible retirement plans, including individual retirement accounts or annuities (“IRAs”). Subject to certain exceptions, § 402(c)(1) provides that if any portion of an eligible rollover distribution paid to an employee from a qualified trust is transferred to an eligible retirement plan, the portion of the distribution so transferred is not includible in gross income in the taxable year in which paid.

Under § 402(c)(2), the maximum portion of an eligible rollover distribution that may be rolled over in a transfer to which § 402(c)(1) applies generally cannot exceed the portion of such distribution which is otherwise includible in gross income. However, under § 402(c)(2)(A) and (B), the general rule does not apply to such distribution to the extent that--

(A) such portion is transferred in a direct trustee-to-trustee transfer to a qualified trust or to an annuity contract described in section 403(b) and

such trust or contract provides for separate accounting for amounts so transferred (and earnings thereon), including separately accounting for the portion of such distribution which is includible in gross income and the portion of such distribution which is not so includible, or

(B) such portion is transferred to an [IRA].

In addition, § 402(c)(2) provides the following special rule:

In the case of a transfer described in subparagraph (A) or (B), the amount transferred shall be treated as consisting first of the portion of such distribution that is includible in gross income (determined without regard to [§ 402(c)(1)]).

Under § 402A, an applicable retirement plan, defined in § 402A(e)(1) to include a plan qualified under § 401(a), a § 403(b) plan, or a governmental § 457(b) plan, may include a designated Roth account. Section 402A(d) provides that a qualified distribution (as defined in § 402A(d)(2)) from a designated Roth account is not includible in gross income.

Section 1.402A-1, Q&A-5(a), of the Income Tax Regulations provides taxability rules for a distribution from a designated Roth account that is rolled over. The regulations provide in part that “any amount paid in a direct rollover is treated as a separate distribution from any amount paid directly to the employee.”

Section 402(f) requires that the plan administrator of a plan qualified under § 401(a) provide any recipient of an eligible rollover distribution with a written explanation describing certain provisions of law. Notice 2009-68, 2009-2 C.B. 423, provides two safe harbor explanations that may be provided to recipients of eligible rollover distributions from an employer plan in order to satisfy § 402(f). The safe harbor explanation with respect to distributions not from a designated Roth account provides in part (under the heading “If your payment includes after-tax contributions”) that “[i]f you do a direct rollover of only a portion of the amount paid from the Plan and a portion is paid to you, each of the payments will include an allocable portion of the after-tax contributions.” Similarly, for distributions from a designated Roth account, the safe harbor explanation provides in part (under the heading “How do I do a rollover?”) that “[i]f you do a direct rollover of only a portion of the amount paid from the Plan and a portion is paid to you, each of the payments will include an allocable portion of the earnings in your designated Roth account.”

Sections 403(b)(8)(B) and 457(e)(16)(B) provide that the rules of § 402(c)(2) through (7), (9), and (11) and the rules of § 402(f) also apply to § 403(b) plans and governmental § 457(b) plans.

In response to Notice 2009-68, comments were received requesting changes to the rules regarding the allocation of basis among simultaneous disbursements to multiple

destinations from a retirement plan that contains both after-tax and pretax amounts. Commenters indicated that some plan providers were treating disbursements to separate destinations not as separate distributions but rather as a single distribution of the aggregate disbursement amounts. These plan providers permitted allocation of all the after-tax amounts included in the disbursements to a Roth IRA. The commenters also pointed out that even under the allocation method described in Notice 2009-68 a participant who wishes to disburse after-tax amounts to one destination and pretax amounts to another could accomplish this result in a series of steps. First, the participant could take an eligible rollover distribution as a single cash distribution. Second, by taking advantage of the rule in § 402(c)(2) that distribution amounts that are rolled over are treated as consisting first of pretax amounts, the participant could roll over the pretax amounts included in the distribution to one destination, such as a traditional IRA. The remaining amount of the distribution would be after-tax, which the participant could either roll over into a Roth IRA or retain without incurring any tax liability. The option to roll over all after-tax amounts into a Roth IRA, however, would only be available to taxpayers with sufficient funds available outside of the plan to be able to roll over the entire amount distributed, including the 20 percent of the taxable portion of the distribution paid to the IRS as withholding pursuant to § 3405(c).

As described in section VI of this notice, this notice is being issued in conjunction with proposed regulations that would modify § 1.402A-1, Q&A-5(a).

III. GUIDANCE ON THE ALLOCATION OF AFTER-TAX AND PRETAX AMOUNTS

For purposes of determining the portion of a disbursement of benefits from a plan to a participant, beneficiary, or alternate payee that is not includible in gross income under the rules of § 72, all disbursements of benefits from the plan to the recipient that are scheduled to be made at the same time (disregarding differences due to reasonable delays to facilitate plan administration) are treated as a single distribution without regard to whether the recipient has directed that the disbursements be made to a single destination or multiple destinations.

If the pretax amount with respect to the aggregated disbursements that are treated as a single distribution is less than the amount of the distribution that is directly rolled over to one or more eligible retirement plans, the entire pretax amount is assigned to the amount of the distribution that is directly rolled over. In such a case, if the direct rollover is to two or more plans, then the recipient can select how the pretax amount is allocated among these plans. To make this selection, the recipient must inform the plan administrator of the allocation prior to the time of the direct rollovers.

If the pretax amount with respect to the aggregated disbursements in a distribution equals or exceeds the amount of the distribution that is directly rolled over to one or more eligible retirement plans, the pretax amount is assigned to the portion of the distribution that is directly rolled over up to the amount of the direct rollover (so that each direct rollover consists entirely of pretax amounts). Any remaining pretax amount is next assigned to any 60-day rollovers (that is, rollovers that are not direct rollovers)

up to the amount of the 60-day rollovers. If the remaining pretax amount is less than the amount rolled over in 60-day rollovers, the recipient can select how the pretax amount is allocated among the plans that receive 60-day rollovers.

If, after the assignment of the pretax amount to direct rollovers and 60-day rollovers, there is a remaining pretax amount, that amount is includible in the distributee's gross income. If the amount rolled over to an eligible retirement plan exceeds the portion of the pretax amount assigned or allocated to the plan, the excess is an after-tax amount.

IV. REPORTING REQUIREMENTS

Even though certain multiple disbursements to different destinations are treated as a single aggregated distribution under the first paragraph of section III of this notice, each disbursement may be required to be reported on a separate Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., in accordance with the Instructions to Form 1099-R. In preparing the Form 1099-R, the assignment and allocation rules in section III must be taken into account in determining the amount of pretax contributions assigned or allocated among direct rollovers and any amounts paid to the recipient.

V. EXAMPLES

Example 1. Employee C participates in a qualified plan that does not contain a designated Roth account. Employee C's \$250,000 account balance consists of \$200,000 of pretax amounts and \$50,000 of after-tax amounts. Employee C separates from service and is entitled to, and requests, a distribution of \$100,000. Under § 72(e)(8), the pretax amount with respect to the distribution is \$80,000 ($\$100,000 \times \$200,000/\$250,000$). Employee C specifies that \$70,000 is to be directly rolled over to the qualified plan maintained by his new employer and that \$30,000 is to be paid to Employee C. Because the pretax amount exceeds the amount directly rolled over, the amount directly rolled over to the new plan consists entirely of pretax amounts. The amount paid to Employee C (prior to application of withholding) consists of \$10,000 in pretax amounts and \$20,000 in after-tax amounts. Prior to the 60th day after the distribution, Employee C chooses to roll over \$12,000 to an IRA. Because the amount rolled over in the 60-day rollover exceeds the remaining pretax amounts, the amount rolled over to the IRA consists of \$10,000 of pretax amounts and \$2,000 of after-tax amounts.

Example 2. The facts are the same as in Example 1, except that Employee C chooses to transfer \$82,000 in direct rollovers -- \$50,000 to the new qualified plan and \$32,000 to an IRA. The remaining \$18,000 is paid to Employee C. The new qualified plan separately accounts for after-tax contributions. Because the amount rolled over exceeds the pretax amount, the direct rollovers consist of \$80,000 in pretax amounts and \$2,000 in after-tax amounts. Employee C is permitted to allocate the pretax amounts between the new qualified plan and the IRA prior to the time the direct rollovers are made.

Example 3. The facts are the same as in Example 2, except that the new qualified plan does not separately account for after-tax contributions. In this case, it is impermissible for the \$2,000 (which represents the after-tax portion of the distribution) to be rolled over to the new qualified plan. Thus, the entire \$50,000 rolled over to the plan must consist of pretax amounts. The \$32,000 rolled over to the IRA consists of \$30,000 of pretax amounts and \$2,000 of after-tax amounts.

Example 4. The facts are the same as in Example 1, except that Employee C chooses to make a direct rollover of \$80,000 to a traditional IRA and \$20,000 to a Roth IRA. Employee C is permitted to allocate the \$80,000 that consists entirely of pretax amounts to the traditional IRA so that the \$20,000 rolled over to the Roth IRA consists entirely of after-tax amounts.

VI. PROPOSED REGULATIONS AND TRANSITION RULES

The allocation rules of section III of this notice generally apply to distributions made on or after January 1, 2015.

Concurrent with this notice, the Federal Register has filed for public inspection proposed regulations under § 402A (REG-105739-11, filed for public inspection by the Federal Register on September 18, 2014). The proposed regulations would limit the applicability of the requirement in § 1.402A-1, Q&A-5(a), applicable to distributions from designated Roth accounts that “any amount paid in a direct rollover is treated as a separate distribution from any amount paid directly to the employee.” Under the proposed regulations, that separate distribution requirement would not apply to distributions made on or after the applicability date of the Treasury decision finalizing the proposed regulations. The applicability date of the regulations is proposed to be January 1, 2015. However, in accordance with § 7805(b)(7), taxpayers are permitted to apply the proposed regulations to distributions made before the applicability date, so long as such earlier distributions are made on or after September 18, 2014. For distributions from designated Roth accounts, the allocation rules of section III of this notice will apply to distributions made on or after the applicability date.

For distributions made on or after September 18, 2014 but before the allocation rules of section III of this notice apply, taxpayers may apply a reasonable interpretation of the last sentence of § 402(c)(2) to allocate after-tax and pretax amounts among disbursements made to multiple destinations. In the case of such disbursements, a reasonable interpretation of the last sentence of § 402(c)(2) includes utilizing the separate distribution allocation rule described in § 1.402A-1, Q&A-5(a). For example, it would be reasonable for a plan administrator to treat each disbursement as a separate distribution that receives a pro rata share of pretax amounts and for the recipient to determine taxability in accordance with that allocation. It would also be reasonable for the plan administrator to allocate pretax amounts in the manner described in section III of this notice as timely selected by the recipient of disbursements made to multiple destinations. In addition, it would be reasonable for a plan administrator to switch from

allocating pretax amounts using the separate distribution allocation rule to allocating pretax amounts in the manner described in section III of this notice as timely selected by the recipient.

For distributions made prior to September 18, 2014, taxpayers may generally apply the same reasonable interpretation standard described in the preceding paragraph. However, if such a distribution is made from a designated Roth account, the allocation of the pretax amounts must be made in accordance with the rules set forth in the § 402A regulations that were in effect on the date of the distribution.

The IRS also intends to revise the safe harbor explanations that may be provided to recipients of eligible rollover distributions from an employer plan in order to satisfy § 402(f) to reflect this revised method for applying the last sentence of § 402(c)(2).

DRAFTING INFORMATION

The principal author of this notice is Kathleen Herrmann of the Employee Plans, Tax Exempt and Government Entities Division. Questions regarding this notice may be sent via e-mail to RetirementPlanQuestions@irs.gov.