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White paper

IRS permits Roth IRA conversion of after-tax plan contributions

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On September 18, 2014, the IRS issued IRS Notice 2014-54, which provides guidance when a qualified plan participant takes a distribution from an employer sponsored qualified retirement plan that contains both pre-tax and after-tax funds. So, now we have clear guidance that a qualified plan participant with both pre-tax money and after-tax money in their qualified plan account can do a direct rollover of the after-tax money and convert it to a Roth IRA, and also do a direct rollover of the pre-tax money to a Traditional IRA. Clients who take advantage of this distribution strategy are able to retain tax deferral on the pre-tax portion of their qualified plan distribution by rolling it over directly to a Traditional IRA, and simultaneously convert ONLY the after-tax portion of their qualified plan distribution to a Roth IRA income tax free.

Please Note: The guidance provided in the Notice does NOT apply to IRA distributions, it only applies to distributions from qualified plans.

An example

John has $250,000 in a 401(k) and is no longer working at the company that sponsors the 401(k) plan. His 401(k) account consists of $200,000 pre-tax money (pre-tax salary deferrals, employer contributions and cumulative earnings) and $50,000 after-tax contributions. Since John is no longer employed by the company, he is eligible to take a distribution of all (or possibly a portion) of his 401(k) account balance. John wants to take all of the money out of the 401(k), but he does not want to pay any taxes.

What are John's options for full rollover?

1. John can do a tax free direct rollover of the entire $250,000 account balance to a Traditional IRA. The entire $250,000 will contain to grow tax deferred, but future earnings on the entire Traditional IRA account (both pre-tax and after-tax money) will be taxable when distributed. In addition, since the Traditional IRA account contains both pre-tax money and after-tax money, any withdrawal will be treated as a distribution from the pre-tax money and after-tax money on a pro-rata basis.

2. John may take advantage of the guidance in the Notice and split the distribution of his entire $250,000 401(k) account balance with the pre-tax money ($200,000) sent as a tax-free direct rollover to a Traditional IRA, and send ONLY the after-tax money ($50,000) as a direct rollover and conversion to a Roth IRA. The $50,000 after-tax money from the 401(k) is converted to a Roth IRA income tax free, and future earnings may be distributed income tax free.

Please Note: The notice does not change the rule that distributions from qualified plans are made pro-rata from pre-tax money and after-tax money in the participant's qualified plan.

How partial rollovers work

The distribution strategy discussed above works simply when clients take a distribution of their entire qualified plan account, but let's see at how it works if John takes a distribution of a portion of his 401(k) account balance instead of all of it.

John decides to take half of his 401(k) account ($125,000.) Since John's 401(k) account is made up of $200,000 of pre-tax money (80% of entire account balance) and $50,000 of after-tax money (20% of entire account balance), this partial distribution is considered as 80% pre-tax money and 20% after-tax money. As a result, John's partial distribution of $125,000 consists of $100,000 from pre-tax money and $25,000 from the after-tax portion.

Remember: The Notice does NOT change HOW the distribution is made from the 401(k) plan. However, the Notice allows John to do a direct rollover of $100,000 of the pre-tax money to a Traditional IRA and a direct rollover and tax free conversion of $25,000 of after tax money to a Roth IRA.

Important considerations

1. If the client wants to do a direct rollover of the pre-tax portion of a distribution to a Traditional IRA and another direct rollover of the after-tax portion to a Roth IRA, they MUST instruct the qualified plan administrator exactly how they want the distribution to be allocated. It is not automatic, and the Notice indicates that the client will have to inform the qualified plan administrator BEFORE the distribution is made. If not, the default allocation may be different.
2. Although a qualified plan must allow participants to do a direct rollover to a different eligible retirement plan (such as an IRA), the qualified plan is NOT required to do multiple direct rollovers from a single distribution – and many will NOT do it. So, what does the client do if the qualified plan won't do multiple direct rollovers? The client can instruct the plan administrator to do a direct rollover of the pre-tax portion of the distribution to a Traditional IRA, and then receive the after-tax portion of the distribution and do a 60 day rollover and tax-free conversion to a Roth IRA. Since the distribution received by the client is considered after-tax money, there is no mandatory 20% withholding on the amount the client receives and rolls over to a Roth IRA within 60 days.
3. The Notice allows a participant to allocate pre-tax and after-tax money to multiple accounts from a SINGLE distribution from a qualified plan. However, it does NOT allow multiple distributions from a qualified plan with 100% of each distribution made to different accounts, since each distribution applies the pro-rata rule and consists of pre-tax and after-tax money.

Key takeaways

Any client with after-tax contributions in his or her employer retirement plan should carefully consider taking advantage of the favorable allocation of pre-tax and after-tax money now allowed by the Notice in order to do a tax-free Roth conversion of the after-tax portion of their qualified plan balance.

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