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New IRS Rules on Direct Rollovers of Taxable and Non-Taxable Amounts Require Changes to Defined Contribution Plan Administration By January 1, 2015

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The Internal Revenue Service (IRS) recently released guidance allowing participants to allocate the taxable and non-taxable portions of a single distribution from a defined contribution retirement plan into separate accounts. The rules apply to distributions beginning January 1, 2015, though participants may select an earlier applicability date in certain circumstances. Sponsors of defined contribution retirement plans should consider how their administrative practices and participant communications may need to be changed in light of these new rules.

Background

A participant in a defined contribution plan qualified under Section 401(a), 403(b) or 457(b) of the Internal Revenue Code who is eligible for a rollover distribution from his or her plan account can elect to have amounts distributed: (1) in a direct rollover to another employer plan, IRA or Roth IRA, and/or (2) in a payment directly to the participant. If payment is made directly to the participant, the participant can make a subsequent "indirect" rollover of amounts distributed to him or her by rolling some or all of that distribution into an IRA or Roth IRA or, with respect to taxable amounts, into another employer plan, within 60 days of the distribution. However, Roth contributions are ineligible for a 60-day rollover to an employer plan.

In some cases, eligible rollover distributions consist of both taxable and non-taxable amounts. For example, a distribution from an account to which a participant made both pre-tax and after-tax contributions would be partially taxable (pre-tax contributions and earnings, plus earnings on after-tax contributions) and partially non-taxable (after-tax contributions, plus Roth contributions and earnings from a qualified distribution). Similarly, a non-qualified distribution from a designated Roth account would be partially taxable (earnings on Roth contributions) and partially non-taxable (Roth contributions).

Under prior IRS guidance, if a participant's account included both taxable and non-taxable amounts, and the participant elected to directly roll over any portion of his or her distribution, each portion would be deemed to consist of a proportionate share of the taxable and non-taxable amounts. Consequently, a participant who wanted to allocate taxable and non-taxable amounts directly to different destinations legally could not do so. Further, a participant was unable to directly roll over the entire taxable portion of his or her account while receiving just the non-taxable portion in cash.

In contrast, if the participant elected to receive his or her entire distribution directly, and roll over all or a portion in a 60-day rollover, the rollover amount would be deemed to consist first of taxable amounts, and then of non-taxable amounts. In essence, to receive the optimum tax result, a participant only could roll over the entire taxable portion of his or her distribution into a pre-tax account through a 60-day rollover, and then either retain or roll over the non-taxable portion into a Roth IRA through a separate 60-day rollover. This complicated "workaround" under prior law allowed participants to indirectly achieve the desired result of separately allocating taxable and nontaxable amounts to different places, which previously could not be accomplished through a direct rollover. However, with this prior method participants rolling over the entire distribution had to use funds outside of their defined contribution accounts to satisfy the 20 percent withholding tax requirement, a disadvantageous cash flow approach.

New Rules

In [Notice 2014-54]() and related [proposed regulations](), the IRS issued guidance eliminating the requirement that participants include a proportionate share of any after-tax contributions when directly rolling over only a portion of their accounts. The IRS also modified the requirement that Roth contribution earnings be separately allocated between the portion directly rolled over and the portion paid directly to the participant. This new guidance allows participants to direct a single distribution of taxable and non-taxable amounts into different retirement accounts, regardless of whether the distribution is a direct rollover or a 60-day rollover, provided that they notify the plan administrator in advance of the distribution from the defined contribution plan.

While the new rules allow participants to direct amounts within a distribution to different destinations, a distribution of part but not all of an account is still treated as consisting of pre-tax and after-tax amounts in proportion to the ratio of each type of contribution to the total account balance. However, the participant now can achieve a different individual tax result using only a direct rollover.

Participants will welcome the increased flexibility and administrative convenience of the new rules. They will now be able to directly roll over after-tax amounts to a separate destination from pre-tax amounts, including to a Roth IRA, without triggering taxes on pre-tax contributions or taxable earnings. In addition, the new rules will simplify rollovers to employer plans when after-tax amounts are involved.

Although the new rules go into effect January 1, 2015, participants may select an applicability date on or after September 18, 2014. In addition, participants whose distributions were made prior to September 18, 2014, may be able to rely on a reasonable interpretation of the new rules, but only with respect to non-Roth amounts. Participants who received distributions from designated Roth accounts prior to September 18, 2014, must allocate Roth earnings in accordance with the old rules.

Next Steps for Defined Contribution Plan Sponsors

Sponsors of defined contribution retirement plans should consider how their administrative practices and participant communications may need to change in light of these new rules. Specifically, plan sponsors should review their rollover election forms to ensure that participants are able to clearly indicate where they wish the taxable and non-taxable portions of their distributions to be sent. Sponsors also should work with record-keepers and trustees to revise their Form 1099-R processes to allow separate Forms 1099-R for allocated amounts to different retirement accounts. In addition, plan sponsors, whose plans do not permit separate accounting for after-tax contributions, should consider altering their record-keeping practices to allow more rollover flexibility for participants.

Finally, defined contribution plan sponsors, whose participant rollover and tax distribution notices are based on the IRS model notice, will need to revise their tax notices to describe the new permitted allocation of after-tax contributions and Roth contribution earnings with direct rollovers. Defined contribution plan sponsors should also review the rollover and tax sections in their summary plan descriptions, in case these summaries contain descriptions of the prior rollover rules on the allocation of taxable and non-taxable distribution amounts.

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