

Retirement Plan News

Allocating pretax and after-tax amounts to multiple destinations

For years, it wasn't clear whether plan participants with after-tax money* in their accounts could roll over the after-tax portion of an eligible distribution to a Roth individual retirement account (IRA) and the pretax portion to another employer's plan or a traditional IRA (or a combination).

In September 2014, the IRS provided the answer – and it was a thumbs up. Notice 2014-54 explains the rules for how to allocate pretax and after-tax amounts that are being distributed at the same time to multiple destinations.

Here's an example: A participant wants one portion of a distribution to go to a new employer's 401(k), another to go to a traditional IRA, and the balance to come to him. According to the guidance, all plan distributions that are scheduled to be made at the same time will be treated as a single distribution without regard to whether the distributed amounts are made to a single destination or multiple destinations. These rules apply to distributions from qualified plans, such as 401(k) plans, and to 403(b) and governmental 457 plans.

Background

Internal Revenue Code (IRC) Section 72(e)(8) requires that partial distributions from participant accounts that contain both pretax and after-tax amounts include pro rata shares of both amounts. IRS Notice 2009-68 provided two model distribution notices with safe harbor explanations that plans can give to individuals who will be receiving eligible rollover distributions. The explanations state that when individuals have one portion of their account directly rolled over and another portion paid to themselves, each of the payments will include a pro rata portion of the after-tax contributions.

The new guidance incorporates IRC Section 402(c)(2), which says that when an amount transferred to a new employer plan or a traditional IRA contains pretax and after-tax amounts, the pretax amount will be distributed first. Thus, this guidance presents a middle-of-the-road approach that incorporates Sections 72(e)(8) and 402(c)(2) and provides new planning opportunities for participants with after-tax amounts who want to arrange a multiple destination distribution.

Applying the new rules

The IRS notice contains four examples



that clarify how payouts that include after-tax amounts and go to multiple destinations will work under the new rules.

The following facts apply in all four examples:

- The plan has no designated Roth provisions
- The participant has a total account balance of \$250,000: \$200,000 pretax + \$50,000 after-tax
- $\$200,000 \text{ (pretax)} \div \$250,000 \text{ (account total)} = 80\% \text{ pretax}$
- Participant severs service and requests a distribution of \$100,000
- Pro rata amounts = \$80,000 pretax and \$20,000 after-tax

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2015 COLA limits

The IRS has released the cost-of-living adjustments applicable to the dollar limitations for pension plans (and other items) for the 2015 tax year.

IRS Limits	2015	2014
401(k), SARSEP, 403(b), and 457 plan deferrals/catch-up	\$18,000/ \$6,000	\$17,500/ \$5,500
SIMPLE plan deferrals/catch-up	\$12,500/ \$3,000	\$12,000/ \$2,500
Compensation defining highly compensated employee*	\$120,000	\$115,000
Compensation defining key employee/officer	\$170,000	\$170,000
Defined benefit plan limit on annual benefits	\$210,000	\$210,000
Defined contribution plan limit on annual additions	\$53,000	\$52,000
Maximum compensation limit for allocation and accrual purposes	\$265,000	\$260,000
IRA contributions/catch-up	\$5,500/ \$1,000	\$5,500/ \$1,000
SEP minimum compensation limit for an allocation	\$600	\$550
QLAC maximum	\$125,000	\$125,000
SSA compensation limit	\$118,500	\$117,000

* 2014 amount for use in 2015 plan year tests

Traditional IRA changes. There also are changes in 2015 to the adjusted gross income (AGI) “phaseout” limits for determining what portion of contributions to a traditional IRA are deductible. For taxpayers who are active participants filing a joint return (or qualified widow(er)s), the deduction is phased out with a combined AGI of \$98,000 to \$118,000 (up from \$96,000 to \$116,000). For taxpayers other than “married filing separate returns,” the deduction phaseout range is \$61,000 to \$71,000 AGI (up from \$60,000 to \$70,000). For a taxpayer who is not an active participant but whose spouse is an active participant, the deduction phaseout range is a combined AGI of \$183,000 to \$193,000 (up from \$181,000 to \$191,000).

Roth IRA changes. There is also an AGI-based limitation for determining the maximum Roth IRA contribution. For married taxpayers filing a joint return (or qualified widow(er)s), the contribution phaseout range is from \$183,000 to \$193,000 (up from \$181,000 to \$191,000). The AGI phaseout range for single taxpayers is \$116,000 to \$131,000 (up from \$114,000 to \$129,000).

In example one, the participant specifies a distribution of \$70,000 by direct rollover to the qualified plan of a new employer:

- All \$70,000 is pretax

The participant requests that \$30,000 be paid to him:

- \$10,000 is pretax, subject to the 20% income-tax withholding
- \$20,000 is after-tax

Within 60 days, the participant rolls \$12,000 into a traditional IRA:

- \$10,000 is pretax
- \$2,000 is after-tax

In example two, the participant specifies a distribution of \$82,000 by direct rollovers:

- \$50,000 to the qualified plan of the new employer
- \$32,000 to a traditional IRA
- \$80,000 of this amount is pretax and \$2,000 is after-tax
- The participant is permitted to allocate the pretax amounts between the IRA and the qualified plan and is to inform the administrator of the choice

The participant requests \$18,000 to be paid to himself:

- All \$18,000 is after-tax

In example three, the participant specifies a distribution of \$82,000 by direct rollovers:

- \$50,000 to the qualified plan of the new employer
- \$32,000 to a traditional IRA
- \$80,000 of this amount is pretax and \$2,000 is after-tax
- The new employer’s plan will not accept after-tax rollovers because it cannot account for after-tax amounts. Thus, the entire \$50,000 rolled over to the new plan must be pretax
- \$2,000 after-tax is all sent to a traditional IRA as part of the \$32,000

The participant requests \$18,000 to be paid to himself:

- All \$18,000 is after-tax

In example four, the participant specifies a distribution of \$100,000 by direct rollovers:

- \$80,000 to a traditional IRA
- \$20,000 to a Roth IRA
- The participant is permitted to allocate the entire pretax portion to the traditional IRA and the entire after-tax portion to the Roth IRA

Effective date

The new rules generally apply to distributions made on or after January 1, 2015. However, taxpayers are permitted to apply the rules to distributions made on or after September 18, 2014.

* After-tax amounts discussed in this guidance are not designated Roth contributions.



Tracking after-tax amounts in traditional IRAs

When a 401(k) participant has after-tax dollars* in his or her account, the plan administrator tracks the amounts and, upon distribution, reports them appropriately on Form 1099-R. But when there are after-tax amounts in a traditional individual retirement account (IRA), they are generally not tracked by the institution holding the IRA. Instead, the IRA owner is responsible for keeping track of after-tax amounts.

Once there are after-tax dollars in one traditional IRA, all of the individual's traditional IRAs are affected — and all distributions must consist of pro rata amounts of both pretax and after-tax dollars until all the IRAs are closed. After-tax amounts are tracked and calculated using IRS Form 8606, *Nondeductible IRAs*.

Calculating pro rata amounts

To calculate the pretax and after-tax portions of IRA distributions for the year, the IRA owner generally must first calculate the total of after-tax amounts in all of his or her traditional IRAs, then divide that amount by the total balance of all the owner's IRAs as of the preceding December 31. Multiply the total amount distributed from the IRA during that year by that ratio to determine the after-tax portion.

For example, assume an individual has traditional IRAs at three different institutions:

	Pretax (+ earnings)	After-tax (basis)	Total
Institution A IRA	\$6,000	\$2,000	\$8,000
Institution B IRA	\$10,000	\$4,000	\$14,000
Institution C IRA	\$18,000	\$6,000	\$24,000
Totals	\$34,000	\$12,000	\$46,000

If the IRA owner takes a distribution of \$5,000 from any of these IRAs, the after-tax amount is calculated by dividing the total of the after-tax amounts in all three IRAs (\$12,000) by the total balance of all three IRAs (\$46,000) and multiplying

that ratio by the total distribution for the year (\$5,000):

$$\$12,000 \div \$46,000 = 0.26 \times \$5,000 = \$1,304.35$$

Using IRS Form 8606, the IRA owner keeps track of his or her remaining after-tax balance by subtracting the distributed amount of \$1,304.35 from the total amount of \$12,000 to arrive at the new after-tax balance of \$10,695.65.

Mission impossible

Because it is very common for people to have more than one traditional IRA, it is impossible for the financial institutions holding the IRAs to accurately track after-tax amounts. In this hypothetical example, the institution that distributed the funds would generally have no knowledge of the correct total basis (after-tax amount) and thus will not be able to adjust the basis appropriately when the \$5,000 is withdrawn.



In addition, the institutions that were not involved with the distribution would generally have no knowledge that there was any change. The IRA owner is not required to inform the institutions holding his or her IRAs that there are after-tax amounts or that those amounts have changed. The IRA owner often doesn't know about this calculation until he or she files Form 8606 along with Form 1040 for the year of the withdrawal.

An institution could attempt to track the nondeductible amount, although it would

require a disclaimer indicating that the IRA owner would have to inform the institution of any change in basis. Since this is not practical, IRA trustees, custodians, and issuers generally do not track IRA basis.

Best practices

Failure to track after-tax amounts can have tax consequences. If the after-tax amount of a distribution can't be determined, the distribution is taxed as if it consists entirely of pretax dollars, and individuals could inadvertently end up being taxed twice on the after-tax portion. The reason for the failure can be as simple as the IRA owner not having any record of the after-tax amount. For example, he or she might have tossed out Form 8606 after seven years along with the corresponding Form 1040, and no further Form 8606 has been filed. The Form 8606 instructions discuss looking back to the last Form 8606 the taxpayer filed to pick up the total after-tax amount — whether the last Form 8606 filed was in 1987 or any year thereafter. But not all taxpayers keep their Form 1040 or Form 8606 beyond seven years.

If the only after-tax amount in a traditional IRA is from a rollover from the IRA owner's retirement plan, the IRA owner will have to prorate all future traditional IRA distributions until all the owner's IRAs are closed. Of course, if the individual has only one traditional IRA, it might be much simpler to keep track of the after-tax amount. But having only one traditional IRA in a lifetime is frequently not the case.

Note to plan sponsors: Given that individuals are responsible for tracking the after-tax dollars in their traditional IRAs, imagine the unintended consequences that might occur when after-tax dollars are involuntarily rolled into a traditional IRA without the IRA owner's knowledge. Putting a participant's after-tax dollars into a traditional IRA without the individual's express consent is not recommended.

* After-tax contributions discussed are not designated Roth contributions.



RECENT developments

▶ **Electronic filing final regs**

On September 29, 2014, the IRS and the U.S. Treasury Department issued final regulations that require certain employee retirement benefit plan statements, returns, and reports to be filed on magnetic media (i.e., electronically) through the IRS's Filing Information Returns Electronically (FIRE) system. These regulations will impact certain filers of Form 5500-EZ and Form 8955-SSA. Plan administrators who file, in aggregate, a total of 250 or more various federal returns (Forms 1099, W-2, 941, 945, and 1120) during the calendar year that includes the first day of the plan year will be required to file electronically.

Form 5500-EZ is used for one-

participant plans. So an employer who sponsors a one-person plan isn't likely to file more than 250 various federal returns in a given year. However, firms that act as plan administrators and file Form 5500-EZ on behalf of numerous employers may be impacted by these rules. The Form 5500-EZ rules are effective for plan years that begin on or after January 1, 2015. The rules for Form 8955-SSA apply to filings for plan years that begin on or after January 1, 2014.

If a filer is required to file electronically and fails to do so, the filer is deemed to have failed to file. A filer may decide to file all of the above forms electronically to avoid confusion or the possibility of failing to file.

▶ **Hybrid plan final regs**

On September 19, 2014, the IRS issued final regulations providing guidance relating to defined benefit pension plans, including cash balance plans and other hybrid retirement plans, that use a lump-sum based benefit formula. A hybrid plan is a type of defined benefit retirement plan that contains certain features associated with defined contribution plans. Based on rules that were proposed in 2010, the regulations offer guidance on many aspects, including acceptable rates of interest crediting, accrual rules, and lump-sum based benefit formulas. The regulations will generally apply to plan years that begin on or after January 1, 2016.

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