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# Rollover of After-Tax Dollars from 401(k) Plans

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## Background

Here's the dilemma. You have a traditional 401(k) that contains both after-tax and pre-tax dollars. You'd like to receive a distribution from the plan, convert only the after-tax dollars to a Roth IRA, and roll the pre-tax dollars into a traditional IRA. (By rolling over/converting only the after-tax dollars to a Roth IRA, you avoid paying any income tax on the conversion.)

For example, let's say your 401(k) plan account balance is $10,000, consisting of $8,000 of pre-tax dollars and $2,000 of after-tax dollars. Can you simply request a total distribution of $10,000, instructing the trustee to directly roll the $8,000 of pre-tax dollars to a traditional IRA and the remaining $2,000 of after-tax dollars to a Roth IRA?

In the past, many trustees allowed you to do just that. But in recent years the IRS had suggested that this result could be achieved only with indirect (60-day) rollovers, not direct rollovers. The legal basis for this IRS position was, however, not entirely clear. (The problem with indirect rollovers is that they are subject to 20% mandatory withholding and, if not executed correctly, could be fully taxable--and distributions prior to age 59½ might also be subject to a 10% federal income tax penalty.)

## IRS Notice 2014-54

On September 18, in Notice 2014-54 (and related proposed regulations), the IRS backed away from its prior position. Based on the Notice, it is finally clear that employer-plan distributions can be split into more than one retirement vehicle with, for example, pre-tax money transferred directly to a traditional IRA (with no current tax liability) and after-tax money moved directly to a Roth IRA (with no conversion tax). Even though the new rules aren't scheduled to go into effect until January 1, 2015, taxpayers can apply this guidance to distributions made on or after September 18, 2014. (The guidance also applies to 403(b) and 457(b) plans.)

The Notice provides the following technical rules:

- When calculating the taxable portion of a distribution from a 401(k) plan, all distributions you receive at the same time are treated as a single distribution, even if the proceeds are going to multiple destinations. This is important for allocating pre-tax and after-tax contributions to a distribution. For example, assume your 401(k) account is $100,000, consisting of $60,000 (6/10s) of pre-tax dollars and $40,000 (4/10s) of after-tax dollars. You request that $20,000 be rolled directly over to an IRA and $20,000 paid to you. This is treated as a single $40,000 distribution from the 401(k) plan. Of this $40,000, $24,000 (6/10s) is pre-tax dollars, and $16,000 (4/10s) is after-tax dollars.

- If you receive a distribution (as defined above), and roll all or part of the distribution over to one or more eligible retirement plans, your pre-tax dollars will be deemed allocated first to any direct rollovers you make, and then to any 60-day (indirect) rollovers you make. After all your pre-tax dollars have been so allocated, any remaining amounts rolled over will consist of after-tax dollars.
- If you are making direct rollovers to more than one eligible retirement plan (or indirect rollovers to more than one plan), you can direct the trustee how to allocate the pre-tax dollars among those retirement plans prior to the time the direct rollovers are made.

## Examples

The Notice includes the following examples:

Julie participates in a 401(k) plan. Her $250,000 account balance consists of $200,000 of pre-tax dollars and $50,000 of after-tax dollars. Julie leaves her job, and requests a distribution of $100,000. The $100,000 distribution is deemed to include $80,000 of pre-tax dollars ($100,000 x $200,000/$250,000), and $20,000 of after-tax dollars ($100,000 x $50,000/$250,000). Julie requests that $70,000 be directly rolled over to the 401(k) plan maintained by her new employer and that $30,000 be paid to her in cash. Because the pre-tax amount of the distribution ($80,000) exceeds the amount directly rolled over ($70,000), the amount directly rolled over to the new plan consists entirely of pre-tax dollars. The remaining amount paid to Julie (prior to any withholding tax) consists of $10,000 in pre-tax dollars and $20,000 in after-tax dollars. Prior to the 60th day after the distribution, Julie chooses to roll over $12,000 to an IRA. Because the amount rolled over in the 60-day rollover ($12,000) exceeds the remaining pre-tax dollars ($10,000), the amount rolled over to the IRA consists of $10,000 of pre-tax dollars and $2,000 of after-tax dollars.

The facts are the same as in Example 1, except that Julie chooses to make $82,000 of direct rollovers -- $50,000 to the new 401(k) plan and $32,000 to an IRA. The remaining $18,000 is paid to Julie. Because the amount rolled over ($82,000) exceeds the pre-tax amount of the distribution ($80,000), the direct rollovers consist of $80,000 in pretax amounts and $2,000 in after-tax amounts. Julie is allowed to allocate the pre-tax dollars between the new 401(k) plan and the IRA prior to the time the direct rollovers are made.

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

## Conclusion

Prior to Notice 2014-54, it was possible to achieve a tax-free Roth conversion of after-tax dollars in an employer plan, but it was a fairly complicated procedure using 60 day (indirect) rollovers, not direct rollovers, which involved several steps and required taxpayers to have sufficient funds outside the plan to make up the 20% mandatory withholding that applied to the taxable portion of the distribution. The ability to accomplish the same result in a more efficient manner using direct rollovers is welcome relief.

IRS Notice 2014-54 is titled Guidance on Allocation of After-Tax Amounts to Rollovers, and can be found at [www.irs.gov/pub/irs-drop/n-14-54.pdf](www.irs.gov/pub/irs-drop/n-14-54.pdf).