March 2015

PENSION ANALYST

Important information – Plan administration

IRS clarifies rollover rules and provides revised rollover distribution notices

Who's affected

This guidance applies to sponsors of and participants in all qualified defined benefit and defined contribution plans, 403(b) plans and governmental section 457(b) plans.

Background and summary

Since 2002, both pre-tax and post-tax amounts distributed from tax-qualified retirement plans have been eligible for rollover to other such plans and IRAs, provided all additional rollover eligibility requirements are met. "Pre-tax amounts" include employee pre-tax deferral contributions under 401(k), 403(b) and governmental section 457(b) plans, as well as employer contributions, and investment earnings on all contributions. "Post-tax amounts" include both standard employee after-tax contributions and designated Roth contributions.

In late 2014, the IRS published four pieces of guidance to clarify the rollover rules for allocating pre-tax and post-tax amounts when a single distribution results in funds being sent to multiple locations. The most common situation in which these rules apply is when a portion of a distribution is directly rolled over to another employer-sponsored plan or IRA and the remainder is distributed directly to the employee. This guidance includes:

- IRS Notice 2014-54, providing guidance on the allocation of after-tax amounts to rollovers;
- A proposed regulation removing the more restrictive allocation rule for disbursements from designated Roth accounts to multiple destinations;
- Notice 2014-74, providing revised safe harbor explanations for eligible rollover distributions (often referred to as "402(f) notices"); and
- A set of Frequently Asked Questions (FAQs) to clarify Notice 2014-54.

The revised rules are effective for distributions made on and after January 1, 2015. However, the IRS permitted plans sponsors to apply them to distributions occurring before that date.

Actions and next steps

Plan sponsors should review the information provided in this publication to understand how it applies to their plans and participants. Prudential Retirement has reviewed its existing procedures and determined that affected rollovers have been processed in accordance with the rules as clarified by the 2014 guidance. In addition, Prudential has been working to update all versions of the 402(f) notices currently in use to reflect the revised explanations provided in Notice 2014-74. We expect to complete this effort in early 2015.

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Partial plan distributions including pre-tax funds and post-tax funds

Many of today's qualified defined contribution and defined benefit pension plans, as well as 403(b) plans and governmental section 457(b) plans contain only pre-tax funds, such as employee pre-tax deferral contributions, employer contributions, and investment earnings. However, some plans also contain post-tax funds, such as employee after-tax contributions and designated Roth contributions.

When a participant's account includes both pre-tax funds and post-tax funds, IRS regulations require any partial distribution from the account to include pro-rata shares of both pre-tax and post-tax amounts. Some exceptions apply to this general rule.

- Any post-tax contributions made to a plan before January 1, 1987 may be distributed without regard to the pro-rata rule.
- Post-tax contributions made to a plan after December 31, 1986 that are accounted for in a subaccount that is separate from other types of contributions are considered to be held under a "separate contract" from those other funds. As a result, distributions made from that subaccount are only required to apply the pro-rata rule to the amounts (post-tax contributions and related earnings) held in that subaccount, and do not have to take into consideration other pre-tax amounts held in the participant's account.

The same rules specifically allow the participant to receive separate payments, permitting the direct rollover of just the pre-tax amounts while the nontaxable post-tax amounts are distributed directly to the participant.

Rollovers involving a combination of pre-tax funds and post-tax funds

Prior to January 1, 2002, post-tax contributions could not be rolled over to other employer-sponsored plans or IRAs. Since the participant had already paid taxes on these amounts, there was no real benefit to be gained by allowing such rollovers. However, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") changed the rollover rules and made these amounts eligible for rollover to traditional IRAs and employer plans that provided separate accounting for these amounts. Still, there was not much interest in rolling over these amounts, with participants more interested in taking these amounts in cash and rolling over the pre-tax funds, to prolong the deferral of income taxation.

The landscape changed more profoundly when the Pension Protection Act of 2006 ("PPA") amended the definition of qualified rollover contribution so that any and all amounts distributed from an employer-sponsored plan could now be directly rolled over to a Roth IRA. While any pre-tax amounts rolled over to a Roth IRA are immediately taxable, it became particularly attractive to directly rollover non-taxable post-tax amounts to a Roth IRA.

When administering requests for partial distributions involving direct rollovers of post-tax amounts to Roth IRAs, payors continued to follow the existing IRS rules allowing participants to designate different destinations for the pre-tax and post-tax amounts that were distributed at the same time. As a result, participants could directly rollover only post-tax amounts to a Roth IRA, while rolling over pre-tax amounts to another employer-sponsored plan or traditional IRA. In fact, this practice continued even after 2009, when the IRS published some contradictory guidance.

Confusion and clarification

In Notice 2009-68, the IRS seemed to indicate that all direct rollovers should be made on a pro-rata basis. This meant that a direct rollover to a Roth IRA would have to include both post-tax and pre-tax amounts, as opposed to just post-tax amounts. However, the IRS never revised the original rules regarding split payments, so many payors continued to follow those rules when processing requests for direct rollovers to multiple destinations involving post-tax and pre-tax amounts, allowing continued direct rollovers of only post-tax amounts to Roth IRAs.

In Notice 2014-54, the IRS officially acknowledged and approved the common practice of allowing participants to treat two or more checks processed at the same time as a single distribution, which allows them to allocate the post-tax amounts as they desire, including as a direct rollover to a Roth IRA. At the same time, the IRS published proposed changes to the designated Roth contribution distribution rules to make sure they were consistent with the guidance provided in Notice 2014-54.

Notice 2014-54 key points

- Required for distributions made on and after January 1, 2015.
- May be applied to distributions made before January 1, 2015.
- All payments scheduled to be made from a plan to a participant at the same time are treated as a single distribution, regardless of whether they are being made to a single destination or multiple destinations. “Destinations” include direct rollovers to other employer-sponsored plans or IRAs, as well as payment directly to the participant.
- If a single distribution includes both pre-tax and post-tax amounts, and direct rollovers are to be made to two or more plans, the participant may select how the pre-tax amounts will be allocated to the rollovers by notifying the plan administrator before the direct rollovers are made.
- If a single distribution includes both pre-tax and post-tax amounts, and a direct rollover is requested for only a portion of the distribution, the rollover is determined as follows:
  - If the **pre-tax** amount is **less than the amount that is to be directly rolled over**, the entire pre-tax amount is assigned to the rollover.
    - If the direct rollover is split between two or more plans, the participant may select how the pre-tax amount is allocated between the rollovers.
  - If the **pre-tax** amount **equals or exceeds the amount that is to be directly rolled over**, the pre-tax amount is
    - First, assigned to the direct rollovers to the limit of those rollover amounts (i.e., each direct rollover consists entirely of pre-tax amounts).
    - Then, to any 60-day rollovers. If this remaining pre-tax amount is less than the amount rolled over in 60-day rollovers, the participant may select how the pre-tax amount is allocated among plans receiving those 60-day rollovers.
    - If any pre-tax amounts remain following the completion of all direct and 60-day rollovers, that amount is includible in the participant’s gross income. However, if all pre-tax amounts are rolled over, any remaining amounts paid to the participant are post-tax amounts.

Revised safe harbor explanations for eligible rollover distributions

Two months after the publication of Notice 2014-54, the IRS published Notice 2014-74 amending the two safe harbor 402(f) notices provided in Notice 2009-68.

The changes to the safe harbor notice for **payments not from a designated Roth account**:

- Clarify the description of 90-day unwind contributions that are not eligible for rollover when the participant asks for a distribution within 90 days of their first automatic contribution.
- Delete a redundant reference to distributed 90-day unwind contributions in the section describing exceptions to the 10% additional penalty tax.
- Clarify the exceptions to the 10% additional early distribution penalty tax from an IRA to refer to certain payments for health insurance premiums.
- Revise the discussion of payments of after-tax contributions to reflect the guidance provided in Notice 2014-54.
- Revise the description of the rules for rollover to Roth IRAs to reflect the revised rollover rules that no longer impose an income limit on participants who want to make such rollovers and no longer require a two-step process.
- Add a section describing in-plan Roth rollovers.

The changes to the safe harbor notice for **payments from a designated Roth account**:

- Revise the description of a partial direct rollover to reflect the Notice 2014-54 provision that the portion directly rolled over consists first of earnings.
- Clarify the description of 90-day unwind contributions that are not eligible for rollover when the participant asks for a distribution within 90 days of the first automatic contribution.
- Delete a redundant reference to distributed 90-day unwind contributions in the section describing exceptions to the 10% additional penalty tax.
- Clarify the exceptions to the 10% additional early distribution penalty tax from an IRA to refer to certain payments for health insurance premiums.

Impact on Prudential Retirement's distribution and notification processes

The clarification provided by Notice 2014-54 confirms the approach that Prudential has taken in processing and tax-reporting distributions from qualified defined contribution plans, 403(b) plans, and governmental section 457(b) plans. As a result, no changes are needed to these procedures.

For all plans, including defined benefit plans, Prudential will implement the use of the revised safe harbor 402(f) notices in early 2015. Some of the revised versions, such as the recorded summaries, may be available sooner than other versions, such as the Spanish translations. Until a new version is available, we will continue to supply the existing notices.

Pension Analyst by Prudential Retirement
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