WRMarketplace
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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: For Qualified Plan Distributions to Multiple Destinations, IRS Effectively Creates Presumption that Rolled-Over Funds Are from Taxable, Pre-Tax Amounts.

MARKET TREND: Given the plethora of types of retirement plan contributions – Roth, traditional, after-tax, nonelective, etc. – simplicity has become increasingly important. Participants in qualified plans often take distributions that consist of taxable, pre-tax funds and nontaxable, after-tax funds with the intent of rolling over the taxable amounts to an IRA or another qualified plan and taking the nontaxable amounts as a cash distribution. Achieving this result, however, requires proper distribution planning.

SYNOPSIS: When a participant takes a distribution from a tax qualified plan, the distribution is treated as taxable to the proportionate extent that the plan account consists of pre-tax funds. Under prior rules, when the participant directed the distribution to multiple destinations, the amount distributed to each destination was further prorated to determine the taxable amount of each portion of the distribution. Under recently issued IRS Notice 2014-54, however, the IRS will now treat distributions to multiple destinations as a single distribution, with the amount rolled over to another qualified plan or an IRA generally treated as consisting of taxable, pre-tax funds to the greatest extent possible.

TAKE AWAYS: IRS Notice 2014-54 greatly simplifies the process by which qualified plan participants who wish to direct their plan distributions to multiple destinations can allocate among the taxable and nontaxable portion of those distributions. Given the importance of retirement planning and the complexity of the Internal Revenue Code ("Code"), consultants should familiarize themselves with the rules of Notice 2014-54 so they can assist their individual clients in developing a tax-efficient strategy for taking distributions from qualified plans and rolling over a portion of those distributions in the manner that most effectively achieves the client's financial planning goals. Consultants to plan sponsors should educate their corporate clients on the new reporting and disclosure requirements associated with the rules established by Notice 2014-54.

MAJOR REFERENCES: *IRS Notice 2014-54.*

The numerous types of retirement plan contributions – Roth, traditional, after-tax, nonelective, etc. – has increased the importance and desirability of simplicity in planning when taking and rolling-over plan distributions. Participants in qualified plans often take distributions that consist of taxable, pre-tax funds and nontaxable, after-tax funds, intending to roll over only the taxable amounts to an IRA or another qualified plan while retaining the nontaxable amounts ("**multi-destination distributions**"). Achieving this result, however, requires proper distribution planning, including an understanding of the recent guidance issued by the IRS with regard to these multi-destination distributions.

TAX ON DISTRIBUTONS GENERALLY

Generally, an individual is subject to income tax on a distribution from a tax qualified plan, a 403(b) tax-sheltered annuity or a governmental section 457(b) plan in the year received, with two principal exceptions:

- Amounts contributed to the plan on an <u>after-tax</u> basis (but not earnings thereon) and qualified distributions from <u>designated Roth</u> accounts under the plan are <u>not</u> subject to income tax; and

- Amounts <u>rolled over</u> from the distributing plan to another tax qualified plan or an IRA are <u>not</u> subject to current taxation (rollovers can either be direct to the chosen destination or made by the participant within 60 days of the distribution (although, for non-direct rollovers, 20% of the taxable amount of the distribution will be withheld for taxes, requiring the participant to use other resources to "make-up" the withheld amount if he or she wants to roll-over the full distribution)).

When a participant's plan account includes both pre-tax and after-tax funds, any distribution from the plan must include a pro rata allocation of these amounts. For example, if a participant's account contains $200,000 of pre-tax funds and $50,000 of after-tax amounts, 80% (*i.e.*, $200,000/[$200,000 + $50,000]) of any distribution must be treated as taxable.

PRIOR TAX TREATMENT (OLD RULES)

Under existing IRS guidance – *i.e.*, IRS Notice 2009-68 – a further proration appeared to be required for certain multi-destination distributions from qualified plans. Specifically, if a participant directly rolled over a portion of a distribution that included pre-tax and after-tax-funds and took the remaining portion of the distribution in cash, a proportionate amount of each portion of the distribution was to be considered taxable and the remainder treated as consisting of nontaxable, after-tax funds.

The position in Notice 2009-68 received a good deal of criticism from people in the retirement plan community, and there was a significant amount of noncompliance with the strict language of that notice. Instead, plan sponsors and recordkeepers allowed participants to direct how the distributions to the different destinations were to be treated, largely because the participant could have achieved this same result through a number of steps – *i.e.,* by taking a distribution of the full amount and then rolling over the taxable portion. The problem was that many participants could not effectuate the full amount of the intended rollover because they did not have the resources to make up the 20% mandatory income tax withholding.

IRS NOTICE 2014-54 (NEW RULES)

In recently issued IRS Notice 2014-54, the IRS announced a position that overturns its prior position in Notice 2009-68. For a multi-destination distribution, a plan participant will no longer have to (1) treat the situation as involving multiple distributions, (2) prorate the distribution into taxable and nontaxable amounts or (3) go through the process of having their entire distribution made to them and then rolling over the desired portion of the distribution.

Now, under Notice 2014-54, for purposes of determining the taxable and non-taxable portion of qualified plan distributions, "all disbursements of benefits from the plan to the recipient that are scheduled to be made at the same time… are treated as a single distribution without regard to whether the recipient has directed that the disbursements be made to a single destination or multiple destinations." Accordingly, the recipient can generally direct which distributions are taxable and non-taxable, provided he or she follows three guidelines set forth in the Notice.

Guidelines

First. If the pretax amount of the aggregate distribution is less than the amount of the distribution that is directly rolled over, the entire pretax amount is treated as having been rolled over. If these pre-tax amounts are rolled over to multiple destinations, then the participant can assign the pretax amounts to the various plans to which the rollovers were made in advance of the time of the distribution.

Second. If the pretax amount of the aggregate distribution is equal to or more than the amount of the distribution that is directly rolled over to another plan, the amount in excess of the amount directly rolled over is treated as the rollover of amounts paid to the participant and then directed to another plan within 60 days, with the participant designating how the pre-tax amount is to be assigned between multiple 60-day rollovers (if applicable).

Third. Any pre-tax amount left over after allocation among direct and 60-day rollovers is treated as includible in the recipient's taxable income.

Examples of Application

1. Assume participant, P, has a $250,000 account balance that includes $200,000 in pre-tax funds (meaning 80% of any distribution must be treated as taxable). P takes a distribution of $100,000, with $80,000 treated as pre-tax funds. P directs the roll-over of $70,000 to her new employer's plan with the remaining $30,000 paid to P. Consistent with the first guideline above, since the amount rolled over ($70,000) is less than the taxable amount distributed ($80,000), the full amount of the rollover is treated as taxable money. As for the amount distributed to P, $10,000 is treated as taxable ($80,000 taxable amount - $70,000 rolled over) and the remaining $20,000 represents nontaxable, after-tax funds.

2. Assume the same facts in #1 above, except that, within 60 days of the distribution, P elects to rollover $12,000 of the $30,000 she received to an IRA. The rollover will be deemed to consist of the $10,000 of taxable money received by P in the distribution, along with $2,000 of after-tax funds. The remaining $18,000 is a distribution to P of nontaxable, after-tax funds.

3. Assume the same facts in #1 except that P chooses to directly rollover $82,000 from the $100,000 distribution – $50,000 to the new employer plan and $32,000 to an IRA. From this amount, $80,000 is treated as taxable pre-tax amounts and $2,000 as after-tax funds. P can direct which destination (employer plan or IRA) receives the after-tax funds but can direct the after-tax amounts to the new employer's plan <u>only if</u> that plan separately accounts for after-tax contributions; otherwise, P must direct the $2,000 in after-tax funds to the IRA.

Effective Date

Notice 2014-54 becomes effective on January 1, 2015. For periods before that date, however, taxpayers can likely achieve the same result as derived via Notice 2014-54, because they are allowed to rely on a reasonable interpretation of the language of the Code, which, notwithstanding Notice 2009-68, would generally permit the direction of pre-tax and after-tax amounts to different destinations.

Reporting and Disclosure

Although a multi-destination distribution will be treated as a single distribution for purposes of allocating the pre-tax and after-tax components of the distribution, the distribution may still constitute separate payments for purposes of determining how many IRS Forms 1099-R will need to be issued. Notice 2014-54 may, however, change the manner in which each Form 1099-R is prepared, because the distributions will reflect different allocations of taxable and nontaxable amounts.

It is also likely that notices to participants describing available rollover options and the tax treatment of their distributions will need to be updated. The Notice indicates that the IRS intends to update its safe harbor notices to participants to reflect the new rules.

TAKE AWAYS

- IRS Notice 2014-54 greatly simplifies the process by which qualified plan participants who wish to direct their plan distributions to multiple destinations can allocate among the taxable and nontaxable portion of those distributions.

- Given the importance of retirement planning and the complexity of the Code, consultants should familiarize themselves with the rules of Notice 2014-54 so they can assist their individual clients in developing a tax-efficient strategy for taking distributions from qualified plans and rolling over a portion of those distributions in the manner that most effectively achieves the client's financial planning goals.

- Consultants to plan sponsors should educate their corporate clients on the new reporting and disclosure requirements associated with the rules established by Notice 2014-54.

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