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Converting Your After-Tax 401(k) Dollars to a Roth IRA

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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 and convert only the after-tax dollars to a Roth IRA. By rolling over/converting only the after-tax dollars to a Roth IRA, you hope to avoid paying any income tax on the conversion.

For example, let's say your 401(k) plan distribution is $10,000, consisting of $8,000 of pre-tax dollars and $2,000 of after-tax dollars. Can you simply instruct 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 not be achieved with multiple direct rollovers. Instead, according to the IRS, each rollover would have to carry with it a pro-rata amount of pre-tax and after-tax dollars. The legal basis for this position, however, was not entirely clear.

IRS Notice 2014-54

Thankfully, in Notice 2014-54 (and related proposed regulations), the IRS has backed away from its prior position. The Notice makes it clear that you can split a distribution from your 401(k) plan and directly roll over only the pre-tax dollars to a traditional IRA (with no current tax liability) and only the after-tax dollars to a Roth IRA (with no conversion tax). The IRS guidance also applies to 403(b) and 457(b) plans.

When applying Notice 2014-54, it's important to understand some basic rules (also outlined in the Notice). First, you have to understand how to calculate the taxable portion of your distribution. This is easy if you receive a total distribution — the nontaxable portion is your after-tax contributions, and the taxable portion is the balance of your account. But if you're receiving less than a total distribution, you have to perform a pro-rata calculation.

This is best understood using an example. Assume your 401(k) account is $100,000, consisting of $60,000 (six-tenths) of pre-tax dollars and $40,000 (four-tenths) of after-tax dollars. You request a $40,000 distribution. Of this $40,000, six-tenths, or $24,000, will be taxable pre-tax dollars, and four-tenths, or $16,000, will be nontaxable after-tax dollars. What this means is that you can't, for example, simply request a distribution of $40,000 consisting only of your after-tax dollars. The Notice requires that you treat all distributions you receive at the same time as a single distribution when you perform this pro-rata calculation (even if you subsequently roll those distributions into separate IRAs).

Taking this example a step further, could you now direct the trustee to directly transfer the $16,000 of after-tax dollars to a Roth

IRA (with no conversion tax) and send the remaining $24,000 to you in a taxable distribution? The answer is no, and this leads to a second basic rule described in the Notice: Any rollovers you make from a 401(k) plan distribution are deemed to come first from your pre-tax dollars, and then, only after these dollars are fully used up, from your after-tax dollars. If you're rolling your distribution over into several different accounts, you get to decide which retirement vehicle receives your pre-tax dollars first.

It's these new rules that allow you to accomplish your goal of rolling over only the after-tax portion of your 401(k) plan distribution into a Roth IRA. Going back to our example, these rules make it clear that you can instruct the 401(k) plan trustee to transfer only your pre-tax dollars — $24,000 — to your traditional IRA, leaving the remaining $16,000 — all after-tax dollars — to be rolled over to your Roth IRA in a tax-free conversion.

[Make sure you understand all the pros and cons when evaluating whether to initiate a rollover from an employer plan to an IRA. Always be sure to (1) ask about possible surrender charges that may be imposed by your employer plan, or new surrender charges that your IRA may impose, (2) compare investment fees and expenses charged by your IRA (and investment funds) with those charged by your employer plan (if any), and (3) understand any accumulated rights or guarantees that you may be giving up by transferring funds out of your employer plan.]

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