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TOPIC: IRS Finalizes Rules Allowing Plan Participants to Prioritize Taxable Distribution Amounts for Roll-Over.

MARKET TREND: Many Americans face challenges when it comes to obtaining financial security in retirement, which is why policymakers have provided incentives to increase retirement savings, including the deferral of taxes on earned income that is devoted to an approved savings vehicle. In the current tax environment, many retirement plan participants want to maximize the tax deferral on qualified plan benefits by rolling over some part of their plan distributions to another qualified plan or IRA. But complications can arise when that distribution is comprised of both taxable and nontaxable amounts. The question often arises: How can I maximize the roll-over for taxable amounts?

SYNOPSIS: Contributions made on behalf of a participant in a qualified plan (and the earnings thereon) generally are taxable to the participant in the year distributed. Some distributions, however, will have both non-taxable and taxable portions (a "partially taxable distribution"). Further, distributions rolled over to another employer's qualified plan or to an IRA are not taxable. Yet, before late 2014, payments of a partially-taxable distribution to multiple destinations (i.e., part paid to the participant and part rolled over to an IRA) required each payment to be prorated into taxable and non-taxable

portions, even though the roll over payment would otherwise be entirely non-taxable. Recently-issued final regulations, however, now confirm prior guidance and allow multiple destination payments of a qualified plan distribution to be treated as if the rolled-over payment consists—to the greatest extent possible—of taxable funds.

TAKE AWAYS: The final regulations allow participants to maximize the tax deferral on qualified plan benefits by allowing partial roll overs to another qualified plan or IRA to come first from the taxable portion of a plan distribution. Consultants should review the final regulations, along with IRS Notice 2014-54, to ensure that they can guide their clients in developing a retirement plan distribution strategy that most effectively accomplishes the client's financial planning goals.

MAJOR REFERENCE: Preamble and Final Treas. Reg. §§1.402A-1, Q&A-5(a); Notice 2014-54.

There are a variety of contributions that can be made on behalf of a participant in a qualified plan – pre-tax 401(k), Roth 401(k), after-tax, employer non-elective, and employer matching contributions. Most of these amounts (and the earnings thereon) are taxable to the participant in the year distributed. Some distributions, however, may be only partially-taxable. Further, distributions rolled over to other qualified plans or an IRA are not taxable. Thus, in the current tax environment, many retirement plan participants will want to maximize the tax deferral on qualified plan benefits by rolling over the taxable portion of distributions to another qualified plan or IRA. Recently finalized regulations have made this option easier to implement.

BEFORE - THE PROBLEM

Before late 2014, if a qualified plan participant took a partially-taxable distribution and directed payments to multiple destinations (*e.g.*, part to the participant and part rolled-over to an IRA), each payment had to be prorated into taxable and non-taxable portions.

> ***Example***: Peter, a participant in a qualified plan, receives a $300,000 distribution, $250,000 of which is taxable and $50,000 of which is nontaxable. Peter directs (1) the roll-over of $200,000 of the distribution to an IRA, and (2) payment of the remaining $100,000 to himself. With regard to the $200,000 roll-over, roughly 83% ($250,000/$300,000), or $166,000, would be considered otherwise taxable money and 17% ($34,000) would be considered a rollover of the nontaxable money. As a result, Peter was precluded from rolling over the full $200,000 from the taxable portion of his distribution.

AFTER - THE SOLUTION

In late 2014, the IRS issued IRS Notice 2014-54 and proposed regulations that allowed the participant to maximize the amount of taxable funds rolled over, providing, instead, that a single distribution that is directed to multiple destinations no longer had to be prorated into taxable and nontaxable amounts. Rather, the amount of the distribution directed to the IRA or other qualified plan is treated as consisting of otherwise taxable money to the greatest extent possible, allowing the participant to achieve the maximum tax deferral.

This tax treatment was conditioned on the following allocation rules set forth in the Notice: (1) if the pre-tax amount of the aggregate distribution is less than the amount of the distribution that is directly rolled over, the entire pre-tax amount is treated as having been rolled over; (2) if the pre-tax amount of the aggregate distribution that is rolled over is equal to or more than the amount of the distribution that is ***directly*** rolled over, 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); and (3) any pre-tax amount left over after allocation among direct and 60-day rollovers is treated as includible in the recipient's taxable income.

In May 2016, the IRS issued final regulations adopting the substance of the 2014 proposed regulations and reinforcing the result described in Notice 2014-54. The preamble to the final regulations indicates that the allocation rules of Notice 2014-54 must be followed.

WHAT IT MEANS PRACTICALLY

The following examples illustrate the practical impact of the final regulations:

1. Assume Peter has a $250,000 account balance that includes $200,000 in pre-tax funds (meaning 80% of any distribution must be treated as taxable). Peter takes a distribution of $100,000, with $80,000 treated as consisting of pre-tax funds. Peter directs the rollover of $70,000 to an IRA.

RESULTS #1	
Prior Law	**Final Regulations**
80% of each portion of Peter's distribution is considered pre-tax funds. So $56,000 (80% of $70,000) of the roll over amount is taxable and $14,000 is non-taxable.	Because the amount directly rolled over is less than the taxable portion of Peter's distribution, $10,000 of the $30,000 not rolled over is treated as taxable, and the remaining $20,000 is non-taxable.

2. Assume the same facts as in #1 above, except that, within 60 days of the distribution, Peter rolls over $12,000 of the $30,000 received directly to an IRA.

RESULTS #2	
Prior Law	**Final Regulations**
Of the $30,000 originally distributed but not rolled over, $24,000 was considered pre-tax funds. Because Peter is making a separate rollover distribution, the full $12,000 being rolled over currently is considered as taxable funds.	The rollover will be considered to consist of $10,000 of taxable money received by Peter in the distribution, along with $2,000 of non-taxable funds. The remaining $18,000 is a non-taxable distribution to Peter.

3. Assume the same facts as in #1 above, except that Peter chooses to make direct rollovers of $82,000, with $50,000 going to a new employer's plan and $32,000 to an IRA.

RESULTS #3	
Prior Law	**Final Regulations**
Because the distribution and rollover is being done in a single transaction, the distribution would have to be prorated, and 82% of the taxable portion of the distribution would be treated as being rolled over. Accordingly, of the $82,000 rolled over, 80% of that amount ($65,600) would be treated as taxable funds.	Of the rolled over amount, $80,000 is treated as taxable and $2,000 as after-tax. Peter can specify which destination receives the after-tax funds, but can only specify that those funds go to the new employer's plan if that plan separately accounts for after-tax contributions; if not, the $2,000 in after-tax funds must go to the IRA.

TAKE AWAYS

The final regulations allow participants to maximize the tax deferral on qualified plan benefits by allowing partial roll overs to another qualified plan or IRA to come first from the taxable portion of a plan distribution. Consultants should review the final regulations, along with IRS Notice 2014-54, to ensure that they can guide their clients in developing a retirement plan distribution strategy that most effectively accomplishes the client's financial planning goals.

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WRM #16-32 was written by Greenberg Traurig, LLP
Jonathon M. Forster
Martin Kalb
Richard A. Sirus
Steven B. Lapidus

Rebecca Manicone
Counsel Emeritus
Gerald H. Sherman 1932-2012
Stuart Lewis 1945-2012