**3704. What are the new rules that expand the use of 401(k) to Roth 401(k) rollovers?**

The American Taxpayer Relief Act of 2012 (ATRA) now permits rollovers of funds (even if they are not otherwise distributable without penalty) from traditional 401(k) accounts into Roth 401(k) accounts without a penalty tax. Prior to this expansion, only 401(k) funds that could otherwise be distributed from a 401(k) on a penalty-free basis (for example, funds distributed after the taxpayer reached age 59 ½ or became disabled)[[1]](#footnote-1) could be rolled over.

ATRA does not limit the amount that a plan participant can roll over. Any amount rolled over pursuant to this provision is treated as a distribution that was contributed in a qualified rollover contribution within the meaning of IRC Section 408A. This provision may be adopted by 401(k) plans, 403(b) plans and governmental 457(b) plans for tax years beginning after 2012.[[2]](#footnote-2)

As under prior law, the amount that is rolled over from a traditional 401(k) into a Roth 401(k) is included in gross income. The taxable amount of the Roth rollover must be included in the participant’s gross income. The taxable amount of an in-plan Roth rollover is the amount that would be includible in a participant’s gross income if the rollover were made to a Roth IRA. This amount is equal to the fair market value of the distribution reduced by any basis the participant has in the distribution.[[3]](#footnote-3) The taxable amount of a distribution that an individual rolls over in an in-plan Roth rollover generally is includible in gross income in the taxable year in which the rollover occurs.

The expanded rollover treatment is optional, so that plan administrators have discretion as to whether to adopt an amendment permitting expanded use of this type of rollover. The IRS has provided that such an amendment must be made by the later of (1) the last day of the first plan year that the amendment is effective or (2) December 31, 2014.[[4]](#footnote-4)

See Q 3704.1 for distribution restrictions that apply following a 401(k) to Roth 401(k) rollover.

**3704.01 Are amounts rolled over to a Roth 401(k) subject to distribution restrictions after the rollover?**

Yes. Though the American Taxpayer Relief Act of 2012 expanded the rules governing rollovers from traditional 401(k) accounts to Roth 401(k) accounts to allow rollovers of otherwise nondistributable amounts, the IRS has issued guidance providing that distribution restrictions will now apply after such amounts are rolled over.

Any amount that is rolled over from a traditional 401(k) to a Roth 401(k) remains subject to the same distribution restrictions that applied to the amounts before the rollover.[[5]](#footnote-5) As a result, if an individual makes a rollover from a traditional 401(k) to a Roth 401(k) before reaching age 59 ½, for example, the rolled over amounts cannot be withdrawn from the Roth 401(k) on a penalty-free basis unless one of the other events described in IRC Section 401(k)(2)(B) has occurred (i.e., unless he or she reaches age 59 ½ or there has been a separation from service, death or disability).

**3704.02 Are otherwise nondistributable amounts that are rolled over from a 401(k) to a Roth 401(k) subject to withholding?**

The withholding requirements of IRC Section 3405 do not apply to otherwise nondistributable amounts that are rolled over from a traditional 401(k) into a Roth 401(k) because such a rollover must be accomplished through a direct rollover.[[6]](#footnote-6)

Further, because a nondistributable rollover cannot, by definition, be distributed to the taxpayer, a taxpayer is not permitted to voluntarily elect that a portion of the distribution be subject to withholding for purposes of meeting the taxpayer’s tax obligations with respect to the rollover. As a result, IRS guidance specifically advises that a taxpayer who elects to roll 401(k) funds into a Roth 401(k) may wish to increase withholding or make estimated payments in order to avoid an underpayment penalty.[[7]](#footnote-7)

**3704.03 Can a plan restrict the types of 401(k) contributions that can be converted to a Roth 401(k)?**

Yes. A plan that adopts an amendment permitting in-plan rollovers from traditional 401(k) accounts to Roth 401(k) accounts can, subject to otherwise applicable nondiscrimination requirements, restrict the types of contributions that can be rolled over. Further, the plan amendment can limit the frequency of these rollovers.[[8]](#footnote-8)

For example, while the American Taxpayer Relief Act of 2012 has expanded the use of 401(k) to Roth 401(k) rollovers so that otherwise nondistributable amounts may be permissibly rolled over, it is up to the plan itself to determine whether it will allow these rollovers. For administrative convenience, a plan may provide that it will only permit rollovers of otherwise distributable amounts or that nondistributable amounts can only be rolled over at certain intervals.

**3620.01 What strategies should a taxpayer consider when determining the level of distributions from retirement accounts during retirement?**

One traditional method for determining the level of distributions that a taxpayer should take from retirement accounts during retirement is the 4 percent rule. An alternative, however, can be to use the IRS’ required minimum distribution (RMD) rules to make the determination.

The RMD rules essentially require that your clients begin withdrawing funds from tax-deferred retirement accounts, such as IRAs and 401(k)s, when they reach age 70½. The minimum amounts that must be withdrawn are calculated based on the taxpayer’s life expectancy, determined using IRS actuarial data.[[9]](#footnote-9)

The IRS provides tables specifying the percentage of current account assets that must be withdrawn each year based on the life expectancy of the taxpayer in any given year after reaching age 70½ (tables are also available for taxpayers beginning withdrawals at younger ages). In the case of a married couple where one spouse is more than ten years younger than the other, the joint life expectancy of the couple is used in the calculation to provide a more realistic estimate of the life expectancy. [[10]](#footnote-10)

The RMD requirements are generally not meant to provide retirees with guidance on the optimal withdrawal rate, but are meant to ensure that the funds in these tax-deferred accounts are used for retirement income, rather than as estate planning vehicles. Because the requirements seek to ensure that the assets are spent during life, they are a viable alternative to the so-called “4 percent rule,” even though this was not the original IRS intent in formulating the rules.

As the name suggests, under the 4 percent rule, the taxpayer withdraws 4 percent of the beginning balance of retirement savings each year during retirement. While the rule is very simple, it can have unintended consequences. For example, the rigid 4 percent-per-year requirement tends to encourage taxpayers to seek out dividend-heavy investments to supplement their otherwise fixed income, regardless of whether those investments are otherwise appropriate.

Further, the 4 percent rule has taxpayers withdraw 4 percent even in years when their assets may have severely underperformed. The converse is also true, as the rule limits taxpayers to 4 percent withdrawals even if they could afford much more.

Some advisors find that the RMD method should be considered as a potential alternative for determining retirement account withdrawal rates to the traditional 4 percent rule. Not only is the RMD approach almost as simple as the 4 percent rule—rather than withdrawing 4 percent each year, the taxpayer would consult the IRS tables to determine the applicable percentage—but it offers much more flexibility.

The RMD rule may be, in many ways, much more realistic than the 4 percent rule because it bases withdrawals on the current value of the taxpayer’s retirement assets. While this requires determining the account values each year, it also allows taxpayers to modify their consumption levels based on actual account performance. Because the percentages are based on life expectancy and vary with age, it is still unlikely that the taxpayer will outlive his assets.

**3708.01 Can a taxpayer whose income level exceeds the limitations for Roth IRA contributions maintain a Roth IRA?**

Yes. Despite the fact that a taxpayer whose income level exceeds the Roth IRA contribution limits cannot contribute directly to a Roth IRA, he or she is permitted to maintain a Roth account. In 2014, the ability to make contributions to a Roth IRA begins to phase out for married taxpayers with income over $181,000 ($114,000 for single taxpayers). Roth contributions are completely blocked for married taxpayers who earn over $191,000 and single taxpayers who earn over $129,000.[[11]](#footnote-11)

While contributions cannot be made directly to the Roth if the taxpayer’s income exceeds the annual income threshold, for tax years beginning in 2010 and after, the income limits that applied to prevent high-income taxpayers from making rollovers from traditional IRAs were eliminated.[[12]](#footnote-12)

Therefore, many high-income taxpayers may make contributions indirectly to a Roth account, via a series of rollovers from traditional IRAs. The taxpayer must first open a traditional IRA if the taxpayer does not already maintain such an account (in 2014, each taxpayer can contribute up to $5,500 to an IRA ($6,500 if the taxpayer is 50 or older).[[13]](#footnote-13) The taxpayer can then roll a portion of the IRA into a Roth account each year, though taxes must be paid on the amounts that are rolled over.

**3636.01 What is a “myRA”?**

The “myRA” is a type of retirement savings account introduced by the government in 2014 that is designed to expand and simplify the use of retirement savings accounts for taxpayers who do not otherwise have access to employer-sponsored retirement savings plans. Essentially, the myRA is designed to be treated as a Roth IRA, except that amounts contributed to a myRA will be invested in Treasury securities, and will earn the same interest rate as the Government Securities Investment Fund in the Thrift Savings Plan for federal employees.

There are no fees associated with a myRA account, which will be portable between employers.[[14]](#footnote-14)

The Treasury Department has indicated that it will begin implementing the myRA program late in 2014, and will issue additional guidance in the future.

See Q 3636.02 for eligibility requirements, Q 3636.03 for contribution rules and Q[11] for distribution requirements.

**3636.02 Who is eligible to open a myRA?**

Initial guidance released by the Treasury Department with respect to the myRA program indicates that the myRA will be available to taxpayers with annual income that is below the inflation-adjusted limitations for contributing to Roth IRAs. This means that individual filers with annual income of less than $129,000 and joint filers with annual income of less than $191,000 (as adjusted for inflation) are eligible to contribute.[[15]](#footnote-15) According to the Treasury Department guidance, it is the individual taxpayer, not the employer, who is responsible for ensuring compliance with these limitations.[[16]](#footnote-16)

While all taxpayers who meet the income limitations are eligible to participate, there is no requirement that all employers offer myRA plans.

**3636.03 How are contributions to a myRA made?**

Employees of participating employees will sign up for myRA accounts online and will make contributions through payroll direct deposit that is arranged through the employer. The initial minimum contribution will be $25. Following the initial contribution, the employee can elect to contribute $5 or more from each paycheck. These contributions will be made automatically via direct deposit into the myRA. Matching employer contributions will not be permitted.[[17]](#footnote-17)

**3636.04 Are there any distribution requirements that will apply with respect to a myRA?**

While not specifically termed a distribution requirement, preliminary guidance has provided that the value of any given myRA account will be capped at $15,000. Once the account value reaches $15,000 (or after 30 years have passed, whichever occurs first), the myRA funds will be rolled over into a private-sector IRA.[[18]](#footnote-18) As of the date of this publication, the rules governing myRA-to-IRA rollovers have not been released.

As with a traditional Roth vehicle, contributions can be withdrawn tax-free. Earnings on the taxpayer’s contributions can be withdrawn tax-free once five years have passed if the taxpayer has attained age 59 ½.[[19]](#footnote-19)

**3631.01 What distribution requirements apply to an inherited IRA where the beneficiary is not the surviving spouse?**

If an IRA owner dies before the required beginning date, distributions must be made under either a life expectancy method or the five-year rule.[[20]](#footnote-20) After-death distributions from a Roth IRA will be determined under these rules because the Roth IRA owner is treated as having died before his or her required beginning date.[[21]](#footnote-21)

Under the life expectancy rule, if any portion of the interest is payable to, or for the benefit of, a designated beneficiary, that portion must be distributed over the life (or life expectancy) of the designated beneficiary, beginning within one year of the owner’s death.[[22]](#footnote-22) To the extent that the interest is payable to a non-spouse beneficiary, distributions must begin by the end of the calendar year immediately following the calendar year in which the IRA owner died.[[23]](#footnote-23) The non-spouse beneficiary’s life expectancy for this purpose is measured as of his or her birthday in the year following the year of the owner’s death. In subsequent years, this amount is reduced by one for each calendar year that has elapsed since the year of the owner’s death.[[24]](#footnote-24)

A person who wishes to use the life expectancy method and fails to timely start distributions may be able to make up the missed RMDs and pay the 50 percent penalty on the missed distributions.[[25]](#footnote-25)

Under the five-year rule, the entire interest must be distributed within five years after the death of the IRA owner (regardless of who or what entity receives the distribution).[[26]](#footnote-26) To satisfy this rule, the entire interest must be distributed by the end of the calendar year that contains the fifth anniversary of the date of the IRA owner’s death.[[27]](#footnote-27)

If the owner of an IRA dies on or after the date distributions have begun (i.e., generally his or her required beginning date), but before the entire interest in the IRA has been distributed, the entire remaining balance generally must be distributed at least as rapidly as under the method of distribution in effect as of the owner’s date of death.[[28]](#footnote-28)

If the IRA owner does not have a designated beneficiary as of the date on which the designated beneficiary is determined (i.e., September 30 of the year after death) the IRA owner’s interest is distributed over his or her remaining life expectancy, using the age of the owner in the calendar year of his or her death, reduced by one for each calendar year that elapses thereafter.[[29]](#footnote-29)

If the owner does have a designated beneficiary as of the determination date, the beneficiary’s interest is distributed over the longer of (1) the beneficiary’s life expectancy, calculated as described above at “Life Expectancy Rule,”[[30]](#footnote-30) or (2) the remaining life expectancy of the owner, determined using the age of the owner in the calendar year of his or her death, reduced by one for each calendar year that elapses thereafter.[[31]](#footnote-31)

See Q 3631 for the treatment of an IRA that is inherited by a surviving spouse.

**3631 What distribution requirements apply to an IRA that is inherited by a surviving spouse?**

While a surviving spouse may elect to treat an inherited IRA in the same manner as a non-spousal beneficiary (see Q[12]), a surviving spouse of an IRA owner who is the sole beneficiary of an IRA and who has an unlimited right to make withdrawals from the IRA may also elect to treat the entire account as his or her own IRA. This election can be made at any time after the IRA owner’s death.[[32]](#footnote-32)

Any minimum distribution that was required to be made to the deceased owner, but had not been made before the owner’s death, must be made to the surviving spouse in the year of death, but in all other respects, required distributions after the owner’s death are determined as if the surviving spouse were the owner.[[33]](#footnote-33)

The surviving spouse will be deemed to have made the election to treat the IRA as his or her own if any required amounts in the account have not been distributed under the requirements for after-death required minimum distributions, or any additional amounts are contributed to the account or to an account or annuity to which the surviving spouse has rolled over the amounts.[[34]](#footnote-34)

The result of a surviving spouse making the election to treat an IRA as his or her own is that the surviving spouse then will be considered the IRA owner for all other income tax purposes (for example, for purposes of the 10 percent penalty on early distributions).[[35]](#footnote-35)

In the event that a surviving spouse beneficiary dies after the IRA owner, but before distributions to the spouse have begun, the five-year rule and the life expectancy rule described above will be applied as though the surviving spouse were the IRA owner.[[36]](#footnote-36) As a result, the distribution period is determined by the life expectancy of the surviving spouse’s designated beneficiary, determined as of September 30 of the year after the surviving spouse’s death. [[37]](#footnote-37) This provision does not allow a new spouse of the deceased IRA owner’s surviving spouse to delay distributions under the surviving spouse rules of IRC 401(a)(9)(B)(iv).[[38]](#footnote-38)

**THIS DOCUMENT IS A REPLACEMENT OF CURRENT 3131 IN TAX FACTS**

**3631.01 Can the beneficiary of an inherited IRA roll funds from a separate retirement accounts into the inherited IRA?**

Yes. Beginning for distributions in 2008, a non-spouse beneficiary of a qualified plan, a tax sheltered annuity, or an eligible Section 457 governmental plan may make a direct rollover into an inherited IRA, including a Roth IRA.[[39]](#footnote-39) The rollover must be made by means of a trustee-to-trustee transfer. The transfer will be treated as an eligible rollover distribution.[[40]](#footnote-40) Distributions to non-spouse beneficiaries prior to 2008 were not eligible rollover distributions.

An inherited IRA created under this provision must remain in the name of the owner of the original retirement account payable to the designated beneficiary. The IRA is subject to required minimum distributions as for any inherited IRA payable to a designated beneficiary (see Q 3631.01 and Q3631).

Because the surviving spouse of an owner of a traditional IRA is not subject to the inherited IRA rules (since the surviving spouse may treat the inherited IRA as though it was his or her own IRA, see Q 3631), the surviving spouse may make rollovers to and from the plan.[[41]](#footnote-41) This generally has held true whether the spouse was the beneficiary designated under the plan or inherited the account as sole beneficiary of the owner’s estate.[[42]](#footnote-42)

**3631.02 Are inherited IRA funds exempt from the claims of a taxpayer’s creditors in bankruptcy?**

Whether or not the funds in an inherited IRA are exempt from the claims of a taxpayer’s creditors in bankruptcy has been an issue that many have disagreed upon in past years, but that the Supreme Court resolved in 2014.[[43]](#footnote-43) Under current law, therefore, the funds in an inherited IRA are subject to the claims of a debtor’s creditor in bankruptcy *if* the account is inherited by abeneficiary *who is not the original account owner’s surviving spouse.*

Traditional and Roth IRAs that are not inherited accounts are typically exempt from bankruptcy claims up to an inflation-adjusted $1 million limit (in 2014, the amount is $1,245,475).[[44]](#footnote-44)

Prior to the Supreme Court’s review of the issue, in some jurisdictions (the Eighth Circuit, for example), inherited IRAs were exempt from bankruptcy claims based on the premise that the funds are retirement funds contained in otherwise tax-exempt vehicles. However, other courts had held that inherited IRAs lack the requisite retirement purpose. The rationale behind this line of decisions (most prominently found in the Seventh Circuit) was that inherited IRAs are subject to an entirely different set of rules than IRAs held by their original owners.

Importantly, while a penalty is imposed on any non-inherited IRA funds that are withdrawn by the owner prior to a certain age, inherited IRA assets are liquid assets that can be accessed by the beneficiary at any time and without penalty. Further, the rules actually require that the inherited IRA funds be withdrawn within a relatively short time frame (either within five years or over the beneficiary’s life expectancy, see Q[12] and Q[13]) set without regard to the typical retirement age.

This split among the circuits prompted the Supreme Court’s recent review of the issue. Though the rule is not settled with respect to *non-spouse* beneficiaries, taxpayers should note that the Supreme Court decision did not address the issue of IRAs that are inherited by a surviving spouse (see Q3631).

1. IRC Sec. 401(k)(2)(B). [↑](#footnote-ref-1)
2. American Taxpayer Relief Act of 2012, Pub. Law No. 112-240, Sec. 902. [↑](#footnote-ref-2)
3. Notice 2009-75, 2009-35 IRB 436; Notice 2010-84, 2010-51 IRB 872. [↑](#footnote-ref-3)
4. Notice 2013-74, 2013-52 IRB 819. [↑](#footnote-ref-4)
5. Notice 2013-74, 2013-52 IRB 819. [↑](#footnote-ref-5)
6. Notice 2013-74, 2013-52 IRB 819. [↑](#footnote-ref-6)
7. IRC Sec. 3402(p); Notice 2013-74, 2013-52 IRB 819. [↑](#footnote-ref-7)
8. Notice 2013-74, 2013-52 IRB 819. [↑](#footnote-ref-8)
9. IRC Secs. 408(a)(6), 408(b)(3), 401(a)(9). [↑](#footnote-ref-9)
10. Treas. Reg. §1.401(a)(9)-9. [↑](#footnote-ref-10)
11. IR-2013-86 (Oct. 31, 2013). [↑](#footnote-ref-11)
12. IRC Secs. 408A(c)(3)(B), 408A(e). [↑](#footnote-ref-12)
13. IR-2013-86 (Oct. 31, 2013). [↑](#footnote-ref-13)
14. See <http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf> for Treasury Department guidance (last accessed July 25, 2014). [↑](#footnote-ref-14)
15. See <http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf> for Treasury Department guidance (last accessed July 25, 2014). [↑](#footnote-ref-15)
16. See Treasury Department myRA Top Questions and Answers, available at <http://www.myra.treasury.gov/readysavegrow/myra/myra_top_questions.htm> (last accessed July 25, 2014). [↑](#footnote-ref-16)
17. See <http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf> for Treasury Department guidance (last accessed July 25, 2014). [↑](#footnote-ref-17)
18. See <http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf> for Treasury Department guidance (last accessed July 25, 2014). [↑](#footnote-ref-18)
19. See Treasury Department myRA Top Questions and Answers, available at <http://www.myra.treasury.gov/readysavegrow/myra/myra_top_questions.htm> (last accessed July 25, 2014). [↑](#footnote-ref-19)
20. Treas. Reg. §1.401(a)(9)-3, A-1(a). [↑](#footnote-ref-20)
21. Treas. Reg. §1.408A-6, A-14(b). [↑](#footnote-ref-21)
22. IRC Sec. 401(a)(9)(B)(iii), Treas. Reg. §1.401(a)(9)-3, A-1(a). [↑](#footnote-ref-22)
23. Treas. Reg. §1.401(a)(9)-3, A-3. [↑](#footnote-ref-23)
24. Treas. Reg. §1.401(a)(9)-5, A-5(c)(1). [↑](#footnote-ref-24)
25. Let. Rul. 200811028. [↑](#footnote-ref-25)
26. IRC Sec. 401(a)(9)(B)(ii); Treas. Reg. §1.401(a)(9)-3, A-1(a). [↑](#footnote-ref-26)
27. Treas. Reg. §1.401(a)(9)-3, A-2. [↑](#footnote-ref-27)
28. IRC Sec. 401(a)(9)(B)(i). [↑](#footnote-ref-28)
29. Treas. Reg. §1.401(a)(9)-5, A-5(c)(3). [↑](#footnote-ref-29)
30. Treas. Reg. §1.401(a)(9)-5, A-5(c)(1), (2). [↑](#footnote-ref-30)
31. Treas. Regs. §§1.401(a)(9)-5, A-5(c)(3); 1.401(a)(9)-5, A-5(a)(1). [↑](#footnote-ref-31)
32. Treas. Reg. §1.408-8, A-5(a). [↑](#footnote-ref-32)
33. Treas. Reg. §1.408-8, A-5(a). [↑](#footnote-ref-33)
34. Treas. Reg. §1.408-8, A-5(b). [↑](#footnote-ref-34)
35. Treas. Reg. §1.408-8, A-5(c); see *Gee v. Comm*., 127 TC 1 (2006). [↑](#footnote-ref-35)
36. IRC Sec. 401(a)(9)(B)(iv)(II); Treas. Reg. §1.401(a)(9)-4, A-4(b); see Let. Rul. 200436017. [↑](#footnote-ref-36)
37. Treas. Reg. 1.401(a)(9)-4,A-4(b). [↑](#footnote-ref-37)
38. Treas. Reg. 1.401(a)(9)-4,A-4(b). [↑](#footnote-ref-38)
39. Notice 2008-30, 2008-1 CB 638, A-7. [↑](#footnote-ref-39)
40. IRC Sec. 402(c)(11). [↑](#footnote-ref-40)
41. IRC Sec. 408(d)(3)(C). [↑](#footnote-ref-41)
42. Let. Ruls. 9820010, 9502042, 9402023, 8925048. [↑](#footnote-ref-42)
43. *Clark v. Rameker,* 134 S. Ct. 2242 (2014). [↑](#footnote-ref-43)
44. 11 U.S.C. §522. [↑](#footnote-ref-44)