Moving Nondeductible Funds from a 401(k) into a Roth IRA
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This article discusses moving basis within a 401(k) plan or a profit sharing plan into a Roth IRA.

A customer wanting to make a direct rollover or rollover contribution of pension funds containing basis should always be advised to consult with his or her tax advisor as this is complicated tax subject. One reason is – the IRS has not been willing to give definitive written guidance.

Discussion of a hypothetical situation is helpful. Let's assume Jane Doe has a 401(k) balance of $50,000, it is comprised of two portions – $40,000 (deductible/taxable contributions and earnings) is taxable and $10,000 is nontaxable (i.e. basis).

Is it possible for Jane to directly rollover the $40,000 of taxable money in the 401(k) plan to a traditional IRA and then directly rollover (i.e. convert) the $10,000 of basis into a Roth IRA?

No. When there is a direct rollover or direct rollovers the pro-rata taxation rule will not allow only the basis to go into the Roth IRA. That is, if $10,000 goes into the Roth IRA, $8,000 of it will be taxable and $2,000 will be nontaxable under a direct rollover approach. Jane will include the $8,000 in her income and pay tax on it. This means she will still have $8,000 of basis with the traditional IRA.

This is not the result she wants. She wants to have no basis within the traditional IRA and she wants only basis to go into the Roth IRA so she will not have to pay any income tax.

Is there an approach allowing Jane to pay no tax with respect to the $10,000 she puts into her Roth IRA?

Yes, but she will need to have access to some additional funds ($8,000) as explained below.

Jane will need to instruct the 401(k) administrator that she wishes to have her plan balance of $50,000 paid to her in cash. She cannot do a direct rollover and achieve the desired result. Since she is paid cash, the plan administrator will withhold 20% of the taxable amount of the distribution. The plan will give her a check for $42,000. 20% must be withheld from the $40,000 or $8,000. 0% must be withheld with respect to the basis (i.e. her own nondeductible contributions). Thus, she is paid $42,000 ($32,000 + $10,000).

Jane now has 60 days to rollover this $42,000 distribution. She may do so by making multiple rollover contributions. First, she wants to rollover the $40,000 into her traditional IRA. Later, she wants to rollover the $10,000 into her Roth IRA. Since she only has $2,000 as the other $8,000 was withheld, she will need to add her own $8,000 to make the $10,000 rollover. This $8,000 can come from other personal funds or possibly from a loan.

Why must she do it this way? Code section 402(c)(2) provides that when a person has basis within the 401(k) plan and takes a distribution, that the taxable amount comes out first and the nontaxable amount comes out second. Because of this rule, she may make a roll over contribution of $40,000 to her traditional IRA and then a rollover contribution of $10,000 to her Roth IRA. The $10,000 she contributes to her Roth IRA will be her basis or the nontaxable amount. In this situation, the pro-rata rule is not used. Although asked numerous times, the IRS has not confirmed that this approach works so that all of the $10,000 going into the Roth IRA is basis and nontaxable.