ASPPA
WORKING FOR AMERICA'S RETIREMENT

Comments on the Proposed Regulations for Designated Roth Contributions under Tax Code Section 402A

April 27, 2006

Department of Treasury
Internal Revenue Service
26 CFR Part 1
[REG-146459-05]

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates this opportunity to comment on the proposed regulations for the taxation and distribution of designated Roth accounts under Internal Revenue Code (IRC) Section 402A as issued by the IRS and Treasury on January 25, 2006 (REG – 146459-05) (Proposed Regulations).

ASPPA is a national society of retirement plan professionals. ASPPA's mission is to educate pension professionals and to preserve and enhance the employer-sponsored pension system. Its membership consists of almost 6,000 actuaries, plan administrators, attorneys, CPAs and other retirement plan experts who design, implement and maintain qualified retirement plans covering tens of millions of American workers.

The Proposed Regulations are a welcome step for practitioners who must implement and administer qualified Roth contribution programs under §401(k) plans and §403(b) arrangements. However, ASPPA requests clarification on several issues addressed in the Proposed Regulations, as well as guidance for additional issues not covered. Issuing timely guidance will allow plan sponsors to implement and administer the Roth feature and help them to achieve compliance in plan operation.

Summary of Recommendations

The following is a summary of ASPPA's recommendations. These are described in greater detail in the Discussion of Issues section.

A. The final regulations should permit rollovers of Roth account distributions between §401(k) plans and §403(b) arrangements.

B. The rule permitting a designated Roth account to be treated as a separate plan under IRC §401(a)(31)(A) (eligible rollover distributions) should also be applied under IRC §401(a)(31)(B) (mandatory IRA rollover provisions).

C. The final regulations should provide that a Roth account distribution described in Treasury Regulation §1.402(c)-2 A-4 be treated for tax purposes in the same manner as an actual distribution from such account.

D. The final regulations should clarify that in the case of USERRA make-up deferrals designated as Roth contributions, the five-taxable year period of participation when determining whether a distribution is a qualified Roth distribution begins on the first day of the taxable year to which the designated Roth make-up deferrals relate.

E. The final regulations should clarify that for self-employed participants who deposit designated Roth contributions after the end of the plan year to which a deferral election relates, the five-taxable year period of participation period begins on the first day of the first taxable year to which the designated Roth contributions relate.

F. The IRC §414(s) regulations should be modified to provide that for IRC §414 (s)(2), designated Roth contributions will be deemed to be amounts that are excludible from compensation pursuant to IRC §402(e)(3) or 403(b). Thus, the safe harbor inclusion or exclusion of elective deferrals under IRC §414(s) would be applicable to both pre-tax elective contributions and designated Roth contributions.

G. The final regulations should clarify that the earnings attributable to a hardship distribution made from a Roth account will be a qualified Roth distribution if the distribution would otherwise be considered a qualifying Roth distribution.

H. The final regulations should clarify that in the case of a participant who elects a direct rollover of a designated Roth account into a subsequent employer's plan, there is one five-taxable year period of participation that applies for both the amount rolled over and the designated Roth contributions made to the new plan.

I. The final regulations should clarify various aspects of the rules regarding rollovers of the taxable portion of Roth account distribution (*i.e.,* the earnings). In addition, the imposition of reporting requirements on a plan accepting a rollover of such amounts should be eliminated.

J. The final regulations should provide that separate contracts used in a single 403(b) arrangement generally should be treated separately when applying the Roth requirements.

K. The final regulations should permit the use of designated Roth contributions in IRC §403(b) arrangements to purchase service credits in a defined benefit plan and provide that such amounts would still be considered designated Roth contributions for tax purposes.

L. The final regulations should provide that when there is a net loss with respect to a designated Roth account, a distribution from such account should be treated in the same manner as a similar distribution from a Roth IRA would be treated.

M. The model special tax notice required under IRC §402(f) should be updated to include a description of the tax treatment of distributions of designated Roth contributions.

Discussion of Issues

A. Rollovers Between §401(k) Plans and §403(b) Arrangements

The Proposed Regulations do not permit eligible rollover distributions of designated Roth accounts between IRC §401(k) plans and IRC §403(b) arrangements. [See Prop. Treas. Reg. §1.402A-1, Q&A-5(a)] This prohibition seems contrary to the intended portability enhancements provided in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and will discourage participants from maintaining designated Roth accounts in the retirement system.

IRC §402A(c)(3)(i) indicates that a rollover contribution may be made only if the contribution is to "another designated Roth account of the individual…." The term "another designated Roth account" in the statute does not limit the rollover to a similar plan, but rather to an "applicable retirement plan." Such term is defined in IRC §402A(e)(1) to include both an IRC §401(a) plan and an IRC §403(b) arrangement. IRC §402(c)(2) does limit rollovers to those amounts otherwise includible in gross income; however, subsection (B) provides an exception for amounts rolled over to an eligible retirement plan as defined in IRC §402(c)(8)(i) and (ii). Therefore, there is no statutory basis for limiting the rollover recipient plan to a plan of the same type.

ASPPA recommends that Treasury modify the definition of applicable retirement plan to include both an IRC §401(a) plan and an IRC §403(b) arrangement, thereby permitting rollovers between such plans and arrangements. This expanded interpretation is consistent with the portability intentions of EGTRRA and would encourage plan participants to keep their accounts in the retirement system. It will also provide increased operational compliance by simplifying the rules applicable to eligible rollover distributions.

B. Application of Automatic IRA Rollover Provisions

The final regulations for designated Roth contributions contain a provision under Treas. Reg. §1.401(k)-(1)(f)(3)(ii) that treats a designated Roth account as a separate plan when applying the minimum $200 threshold for determining whether a distribution is an eligible rollover distribution subject to IRC §401(a)(31)(A). Neither the final regulations nor the Proposed Regulations, however, provide a similar rule for the treatment of designated Roth accounts when applying the automatic rollover rules under IRC §401(a)(31)(B).

IRC §401(a)(31)(B) requires that mandatory distributions of amounts in excess of $1,000 be automatically rolled over to an IRA should a participant fail to make an affirmative election with respect to the distribution. If a distribution subject to IRC §401(a)(31)(B) consists of amounts attributable to designated Roth contributions and non-Roth contributions, then two IRAs would need to be established: a traditional IRA and a Roth IRA.

Without separate treatment of designated Roth accounts, a plan may be required to establish separate IRAs for amounts that individually do not exceed $1,000, but exceed $1,000 in the aggregate. Separate IRAs will result in inefficiencies and additional costs that will likely be borne by participants. Plan administrators also will find it more difficult to find suitable automatic IRA providers for amounts less than $1,000.

For example, assume a plan participant has an account balance of $400 for a designated Roth account and $900 of non-Roth funds. Since the entire vested interest exceeds $1,000, the Proposed Regulations would require both accounts to be subject to the automatic rollover rule under IRC §401(a)(31)(B) in the absence of an affirmative participant election. Thus, the plan administrator would have to open up a traditional IRA for both accounts.

In addition, even if the $1,000 rule is not applied separately to the Roth and non-Roth portions of an account, it is not clear under the Proposed Regulations how the separate application of the $200 rule interacts with the automatic rollover rule. For example, assume the designated Roth account is $100 and the remainder of a participant's account (the non-Roth assets) totals $2,000. The participant terminates employment and the plan provides for mandatory distributions of amounts less than $5,000. If the participant fails to make an affirmative election with respect to the distribution, then it is not clear whether the plan is required to establish a separate Roth IRA for the $100 designated Roth account, or whether the separate application of the $200 rule allows for the cash-out of the designated Roth account, even though the non-Roth assets must be automatically rolled over to a traditional IRA.

Permitting the separate treatment of designated Roth accounts for all IRC §401(a)(31) purposes would alleviate the confusion presented in the above examples, and provide consistency of application and needed administrative simplicity.

ASPPA recommends that the rule permitting a designated Roth account to be treated as a separate plan under IRC §401(a)(31)(A) also be applied for IRC §401(a)(31)(B). In the first of the two examples above, neither the Roth funds nor the non-Roth funds would be subject to the automatic rollover rule under IRC §401(a)(31)(B) because neither amount is over $1,000. In the second of the two examples above, only the non-Roth funds would be subject to the automatic rollover rule under IRC §401(a)(31)(B), because the amount of those funds exceeds $1,000, and the non-Roth funds would be subject neither to the direct rollover election under IRC §401(a)(31)(A) nor the automatic rollover rule under IRC §401(a)(31)(B) because the amount is less than $200. Uniform treatment would simplify administration and participant communications, reduce costs (that may ultimately be borne by participants) and foster operational compliance.

C. Treatment of Distributions Described in Regulation §1.402(c)-2 A-4

Proposed Treasury Regulation §1.402A-1, Q&A-11, provides that Roth account distributions described in Treasury Regulation §1.402(c)-2 A-4 will always be considered a non-qualified distribution. Thus, deemed distributions of defaulted loans under IRC §72(p), costs attributable to current life insurance protection and deductible dividends paid on employer securities (unless reinvested) will not be qualified Roth distributions even if other requirements for a qualified Roth distribution have been satisfied.

There does not appear to be any statutory authority for this position. If a participant has met the requirements for a qualified Roth distribution (*e.g.,* satisfied the five-taxable year period of participation and attained age 59½), then there is no statutory requirement that a distribution described in Treasury Regulation §1.402(c)-2 A-4 be taxable. That regulation provides that these amounts are not “eligible rollover distributions.” However, whether an amount is an “eligible rollover distribution” has no impact on its tax treatment. The fact that an amount paid from a designated Roth account is not eligible for rollover is not a basis for its tax treatment, and equating rollover eligibility with other tax rules is unsupported by the statute or other Treasury regulations.

For example, the Proposed Regulations cite Treasury Regulation §1.72(p)-1, A-11 through -13 to support the position that a deemed distribution from a designated Roth account due to a defaulted loan is not a qualified Roth distribution. However, A-11 provides that a deemed distribution is generally treated as a distribution under IRC §72. Furthermore, this regulation (as well as the other cited regulations) has not been modified to address the treatment of designated Roth contributions. Thus, citing those regulations without any underlying basis for doing so under the statute is inappropriate.

ASPPA recommends that the final regulations provide that a Roth account distribution described in Treasury Regulation §1.402(c)-2 A-4 be treated for tax purposes in the same manner as an actual distribution from such account. Thus, for example, to the extent an amount would be treated as a qualified Roth distribution, no portion of such amount would be taxable, pursuant to IRC §72(p), regardless of whether there is an actual distribution or a deemed distribution.

D. USERRA Make-up Deferrals

The final regulations under IRC §414(u) (USERRA), as well as both the final and Proposed Regulations relating to designated Roth contribution, are silent on the treatment of USERRA make-up deferrals designated as Roth contributions and the application of the five-taxable year period of participation. The rules under IRC §414(u)(1)(B) provide that USERRA make-up contributions are subject to the limitations of the year to which they are attributable. If the make-up contributions are designated Roth contributions, then it would be consistent to treat these contributions also as having been made in the year to which they relate when determining the five-taxable year period of participation and when determining whether a subsequent distribution is qualified as Roth.

For example, assume a participant is on military leave for all of 2006, 2007 and 2008. The plan adopted a qualified Roth contribution program as of January 1, 2006. Upon resuming employment in 2009, the participant elects to designate make-up deferrals for 2006 as a Roth contribution. These deferrals should be considered to have been contributed in 2006 when determining whether the five-taxable year period has been satisfied.

ASPPA requests clarification in the final regulations that, in the case of USERRA make-up deferrals designated as Roth contributions, the five-taxable year period of participation begins on the first day of the taxable year to which the designated Roth make-up deferrals relate.

E. Self-Employed Participants

Self-employed individuals may deposit salary deferral contributions for a given plan year anytime through the due date of their tax return, provided a deferral election has been made prior to the last day of the plan year. The deferral that is made after the end of the plan year is attributable to the plan year in which the deferral election was made (rather than the year in which the amount is deposited). Similar to USERRA make-up contributions discussed above, in this situation, the five-taxable year period of participation for determining whether a distribution is a qualified Roth distribution should start with the taxable year to which the deferral relates.

ASPPA requests clarification in the final regulations that, in the case of self-employed individuals, the five-taxable year period of participation begins with the first taxable year to which a designated Roth contribution is attributable.

F. IRC §414(s) Definition of Compensation

A plan may exclude certain salary deferrals, that are not includible in gross income pursuant to IRC §402(e)(3) or 403(b), from a safe harbor definition of compensation under IRC §414(s). Designated Roth contributions, however, are not excludible from gross income pursuant to IRC §402(e)(3) or 403(b). For both policy and practical purposes, designated Roth contributions should be treated the same as pre-tax deferrals under IRC §414(s).

For qualification purposes, designated Roth contributions generally are treated in the same manner as pre-tax deferrals. Providing different treatment under IRC §414(s) would be inconsistent with this principle and could lead to inadvertent operational violations. In addition, divergent treatment would create a preference for making Roth contributions because it would not impact compensation for plan purposes and could be used to permit situations that would appear to be discriminatory.

For example, assume the majority of highly compensated employees (HCEs) in a plan elects to make designated Roth contributions and the majority of non-highly compensated employees (NHCEs) elects to make pre-tax deferrals. Under IRC §414(s) regulations, pre-tax elective deferrals could be excluded from plan compensation and the definition would be non-discriminatory. Thus, the compensation of the HCEs would not be lowered by the designated Roth contributions while the compensation of the NHCEs would be lowered by their pre-tax deferrals. The result would be to increase the deferral percentages (or average benefit percentages) of the NHCEs, while leaving the percentages of the HCEs unchanged, making the ADP test (or other nondiscrimination testing) easier to pass.

ASPPA recommends that the IRC §414(s) regulations be modified to provide that for IRC §414(s)(2), designated Roth contributions be deemed to be amounts that are excludible from compensation pursuant to IRC §402(e)(3) or 403(b). Such a change would be more consistent with the policy reasons behind a safe harbor definition of nondiscriminatory compensation.

G. Hardship Distributions

Proposed Treasury Regulation §1.402A-1, Q&A-8 provides that hardship distributions under IRC §401(k)(2)(B) are treated as pro-rata distributions of designated Roth contributions and earnings. Hardship distributions are not included in Q&A-11, which identifies distributions that are never considered qualified. [See Prop. Treas. Reg. §1.402A-1, Q&A-11]. Although a portion of the hardship is treated as earnings, it appears that the earnings portion is not includible in taxable income if the recipient is eligible to receive a qualified distribution (*i.e.,* completed the five-taxable year period of participation and attained age 59½). The Proposed Regulations, however, do not include an example of an individual in these circumstances.

ASPPA requests clarificationthat Roth account hardship distributions received after satisfaction of the five-taxable year period of participation and attainment of age 59½, death or disability, are qualified distributions.

H. Direct Rollovers and Subsequent Designated Roth Contributions

Proposed Regulation §1.402A-1, Q&A-4 provides that the five-taxable year period of participation for a Roth contribution rollover relate back to the first year in which a designated Roth contribution was made into the plan. The Proposed Regulations do not make a distinction between an amount that is directly rolled over and those subsequently designated Roth contributions. Because the statute does not require separate five-taxable year periods of participation for the different accounts within the recipient plan (*i.e.,* the designated Roth contribution account and the Roth rollover account), it appears clear that the five-taxable year period of participation that is tacked on from the rollover account should apply for all purposes in the recipient plan, including in relation to new Roth contributions.

ASPPA requests that the final regulations clarify that in the case of a participant who elects a direct rollover of a designated Roth account into a subsequent employer's plan, the five-taxable year period of participation for the amount rolled over also applies to the designated Roth contributions made to the new plan.

I. Eligible Rollover of Taxable Distributions

The Proposed Regulations address various issues regarding the rollover of a taxable distribution (earnings) attributable to a Roth distribution. There are various aspects of the Proposed Regulation, however, where clarifications and/or modifications are needed.

1. Direct rollovers and nonqualified distributions

The Proposed Regulations provide that when a partial rollover is made during the 60-day rollover period, the taxable amount of the Roth distribution (*i.e.,* earnings attributable to a nonqualified distribution) is treated as the first dollars to be rolled over. It is not clear whether this treatment is the case when the rollover is made from a direct rollover.

ASPPA requests clarification that in the case of a partial rollover of a Roth distribution from a direct rollover, the rolled over amount is treated first as attributable to the taxable amount of the distribution.

2. Treatment of rollovers of nonqualified distributions

The Proposed Regulations provide that the five-taxable year period of participation from a distributing plan does not carry over to a qualified plan or to a Section 403(b) plan accepting a 60-day rollover from a Roth account distribution. It is not clear, however, whether the amounts rolled over to such a plan remain as amounts attributable to designated Roth contributions (*i.e.,* whether such amounts may be subsequently distributed as a qualified Roth distribution if the requirements have been satisfied). For example, suppose a participant's designated Roth account is $30,000; $21,000 is basis and $9,000 is earnings. The $30,000 account is distributed in a nonqualified Roth distribution. Within 60 days of the distribution, the participant rolls over $9,000 (representing the taxable portion) to an eligible retirement plan. Since the amount represents the earnings on Roth contributions under the distributing plan, the recipient plan would account for the rollover as a designated Roth account. Thus, after the participant meets the five-year rule under the recipient plan, distributions from that account can be treated as qualified Roth distributions (assuming the qualifying event requirement is satisfied).

ASPPA requests clarification that the taxable amount of a Roth account distribution that is rolled over to another eligible retirement plan, whether by direct rollover or by 60-day rollover, retains its character as an amount attributable to a Roth contribution provided such amount is held in a designated Roth account.

3. Reporting the receipt of an eligible rollover distribution

The Proposed Regulations require a plan receiving a designated Roth account distribution to report to the IRS the receipt of an eligible rollover distribution. It is not clear why Form 1099-R is not sufficient. The Form 1099-R issued with the distribution provides the reporting information needed by the IRS, and if the individual rolls over any part of the taxable portion of the distribution, the information reported on the individual's income tax return indicates the completion of the rollover. Thus, the additional reporting requirement by the recipient plan appears to serve no useful purpose and will add to the cost of a plan, which may be borne by participants and beneficiaries.

ASPPA recommends that the final regulations remove the requirement that a plan accepting a rollover report to the IRS the receipt of such rollover.

J. Multiple Vendor 403(b) Arrangements

Many 403(b) plans, such as 403(b) plans sponsored by public schools, have multiple 403(b) contract vendors. A participant in such a plan could have several 403(b) contracts from different vendors under his or her employer's 403(b) plan. The application of the rules under the Proposed Regulations can vary dramatically depending on whether these multiple contracts are aggregated or treated separately when applying such rules.

1. Ability to Make Roth Contributions

If one 403(b) contract permits an individual to make designated Roth contributions, it is not clear whether all 403(b) contracts of that individual will be required (or could contractually be changed even if desired) to permit designated

Roth contributions. This issue will be even more acute should the Treasury impose a written plan document requirement as set forth in the proposed IRC §403(b) regulations.

ASPPA recommends that each contract be considered separately for determining a plan's ability to make designated Roth contributions.

2. Hardship distributions

The requirement that hardship distributions of designated Roth contributions represent a portion of earnings for tax purposes is particularly onerous in a multiple vendor 403(b) context and would be next-to-impossible to administer. Most vendors' systems would not be able to do the various calculations and would not be able to track them for future distributions. For example, it is not clear how distributions for hardship purposes would be accounted for in a multiple vendor environment when a hardship distribution is made from one contract and not another, but all contracts purchased for an employee are treated as one contract.

ASPPA recommends that each contract be considered separately when applying the hardship distribution provisions. Thus, if a Roth account hardship distribution is made from one vendor's contract, then the tax treatment of such distribution would be based solely on the amounts held in such contract.

3. Required Minimum Distributions

The Proposed Regulations are not clear on the extent to which each 403(b) contract under an employer's 403(b) arrangement will be treated as a separate contract for required minimum distributions under IRC §401(a)(9).

Under current rules, required minimum distributions for each 403(b) contract are calculated separately but can be withdrawn from one 403(b) contract. It is not clear how this would be applied in the case of a participant that has a contract that consists only of pre-tax deferrals and another contract that contains Roth deferrals or a combination of the two. For example, could the required minimum distribution be withdrawn from both the employee's contracts, or just from the contract with the Roth 403(b) contributions?

ASPPA recommends that the current rules be maintained and that each contract be considered separately for determining required minimum distributions, but that the participant may designate the contract from which the distribution will be made.

K. 403(b) Transfers and Service Credit Purchases

IRC §403(b) funds are often transferred (*i.e.,* not by rollover) from one 403(b) plan to another or from one 403(b) contract to another. Public school and university employees may be permitted to make in-service transfers from their 403(b) plans to a state defined benefit plan to purchase service credits under the state defined benefit plan. These transfers are non-taxable and are not tax reported. It is not clear whether designated Roth contributions can be used for such a purpose, and if so, how such funds are treated in the defined benefit plan.

ASPPA recommends that the final regulations permit the use of designated Roth contributions to purchase service credits in a defined benefit plan and that such amounts still be considered designated Roth contributions for tax purposes.

L. Tax Treatment of Losses Attributable to Roth Contributions

In a Roth IRA, if an individual has a net loss and receives a distribution, then the distribution is not taxable (since there are no positive earnings) and the individual can take a deduction for the loss. The Proposed Regulations do not address the treatment of losses for a designated Roth account.

ASPPA recommends that the final regulations provide that when a designated Roth account realizes a net loss, that a distribution from such account be treated in the same manner as a Roth IRA distribution. For this rule, the separate contract provisions of IRC §72 should be applied (thus the net loss in a Roth account is determined solely with respect to amounts in such Roth account).

M. Safe-Harbor Distribution Notice

The current model "Safe Harbor Explanation" to meet the notice requirements under IRC §402(f) has not been updated since the release of IRS Notice 2002-3. A number of significant changes to the rules governing the distribution and taxation of qualified plan accounts has occurred since that time. Plan sponsors must either draft their own notice and forego the use of a safe-harbor notice or provide participants the current safe-harbor notice that does not include a full explanation of all the options available. The ability to use an IRS-provided notice that satisfies the requirements of IRC §402(f) is beneficial to both service providers and employees. It ensures that consistent and accurate information is provided to all participants and aids in compliance.

ASPPA recommends that Treasury update the model safe-harbor explanation to include a description of the automatic rollover rules provided under IRC §401 (a)(31)(B), as well as information on the tax impact of a designated Roth contributions distribution.

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These comments were prepared by the 401(k) Subcommittee of ASPPA's Government Affairs Committee and were primarily authored by Robert M. Kaplan, CPC, QPA, Vice chair, and Adam C. Pozek, QKA. Please contact us if you have any comments or questions regarding the matters discussed above. Thank you for your consideration.

Sincerely,