

IRALERT

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TO: IRA Group Distribution

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RE: Final Roth Distribution Regulations

Last Friday, the Service issued the final regulations on distributions from Roth 401(k) and 403(b) plans. Because this set of regulations deals primarily with distributions and rollovers, there are several things we would like to point out of particular interest to IRA providers. But first, just a little explanation of what they generally provide. Most importantly, the final regulations retain the general approach from the proposed regulations for taxation of nonqualified distributions and provide that a distribution from a designated Roth account that is not a qualified distribution is taxable to the distribute under section 402 (or section 403(b)(1)), treating the designated Roth account as a separate contract under section 72, and not as if it were a distribution from a Roth IRA.

In addition, the final rules generally track the proposed regulations that a rollover from a Roth account to another Roth account must be made directly, but a rollover from a Roth account to a Roth IRA can be made as a 60-day rollover. As under the proposed regulations, if a distribution is not a qualified distribution and a part is taxable, any amount rolled over is deemed to first come from the otherwise taxable portion. The final regulations also retain the rule that Roth IRAs cannot be rolled over into Roth plan accounts. These rules are effective January 1, 2006.

The final regulations allow plan to plan transfers between 401(k) Roth accounts and 403(b) Roth accounts, and vice versa, essentially treating them as equivalent, a change from the proposed regulations.

Some of the principal things we would like to note about the final regulations that may be of interest to Roth IRA providers include that:

- The final regulations clarify that an individual may establish a Roth IRA to accept a direct rollover from a Roth account even if the individual is not eligible to make regular Roth IRA contributions or conversion contributions due to the AGI limit.

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- The final regulations retain the rule under the proposed regulations that the 5-taxable-year period described in section 402A (for Roth accounts) and the 5-taxable-year period described in section 408A(d)(2)(B) (for Roth IRAs) are determined independently. Thus, in the case of a rollover of a distribution from a designated Roth account maintained under a section 401(k) or 403(b) plan to a Roth IRA, the final regulations, like the proposed regulations, provide that the period that the rolled-over funds were in the designated Roth account does not count towards the 5-taxable-year period for determining qualified distributions from the Roth IRA.
- The final regulations provide that the balance of a participant's designated Roth account and a participant's other accounts under a plan are treated as accounts held under two separate plans for purposes of applying not only the special rule §1.401(a)(31)-1, A-11, for de minimis distributions (reasonably expected to total less than \$200) but also both the automatic IRA rollover rules for mandatory distributions under section 401(a)(31)(B) and the rules in §1.401(a)(31)-1, A-9 and 10, on the extent to which plans must allow split distributions. Thus, for example, if a participant has less than \$1,000 in the participant's designated Roth account and less than \$1,000 in the participant's other accounts, the plan will not need to provide the participant with an automatic rollover to an IRA with respect to the designated Roth account or the other accounts even if the total accrued benefit of the participant under the plan exceeds \$1,000.
- The final regulations retain the rule from the proposed regulations that any transaction or accounting methodology involving an employee's designated Roth account and any other accounts under the plan or plans of an employer that has the effect of directly or indirectly transferring value from another account into the designated Roth account violates the separate accounting requirement under section 402A. Commentators asked for additional guidance on how this requirement is satisfied, but the IRS and Treasury Department did not include any guidance in these regulations. However, this issue will continue to be considered by the IRS and Treasury Department. We remain concerned by what this rule will mean in practice and how broadly it may be read, and whether the concept has implications for Roth IRAs and traditional IRAs as well.
- A qualified distribution is generally a distribution that is made after a 5-taxable-year period of participation and that either (1) is made on or after the date the employee attains age 59½, (2) is made after the employee's death, or (3) is attributable to the employee's being disabled. In response to comments, the final regulations clarify that, in the case of distribution to an alternate payee or beneficiary, the age, death or disability of the participant are used to determine whether the distribution is qualified. The only exception is in the case of a rollover by an alternate payee or surviving spouse to a designated Roth account under a plan of his or her own employer.

- The final regulations provide that designated Roth contributions made by a reemployed veteran are treated as made in the taxable year with respect to which the contributions relate. Reemployed veterans may identify the year for which a contribution is made for other purposes, such as for entitlement to a match, and the treatment for the five year period of participation rule follows that identification. Absent such an identification, for purposes of determining the first year of the five years of participation, the contribution is treated as made in the veteran's first taxable year in which the veteran's qualified military service begins, or if later, the first taxable year in which designated Roth contributions could be made under the plan.
- The determination of whether a payment is a qualified distribution is determined based upon the actual year of the payment from the account and does not take into account whether the payment is part of a series of distributions or whether the payment is attributable to a prior calendar year.
- The plan administrator or other responsible party of a plan directly rolling over a distribution is required to provide the plan administrator of the recipient plan or IRA with a statement indicating either the first year of the 5-taxable-year period for the employee and the portion of such distribution attributable to basis or that the distribution is a qualified distribution. If the distribution is not a direct rollover to a designated Roth account under another eligible plan, for example, a rollover to a Roth IRA, the plan administrator or responsible party must provide to the employee, upon request, this same information, except the statement need not indicate the first year of the 5-taxable-year period.

The final regulations under section 402A are generally applicable for taxable years beginning on or after January 1, 2007. However, as noted, the provisions for dealing with rollovers to designated Roth accounts and Roth IRAs are generally applicable for taxable years beginning on or after January 1, 2006.

Please feel free to direct questions to any of the Groom principals listed above or to IRA@groom.com.

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