GROOM LAW GROUP

March 29, 2010

MEMORANDUM TO CLIENTS

RE: **Allocating "Basis" in Partial and Split Rollovers – Can We Still Rely on Code Section 402(c)(2)?**

Many plans and third party administrators (TPAs) thought "yes" as well-settled law following EGTRRA, but the Service seems to disagree.

EGTRRA expanded the rollover provisions to permit the rollover of after-tax amounts (directly and indirectly), and expressly provided in the flush language of Code section 402(c)(2) that the amount transferred shall be treated as consisting first of "the portion of such distribution that is includible in gross income." The legislative history similarly stated that "if a distribution includes both pretax and after-tax amounts, the portion of the distribution that is rolled over is treated as consisting first of pretax amounts." Accordingly, plan sponsors and TPAs have historically permitted a participant to directly or indirectly roll over the entire pre-tax amount first. For example, if the participant took a full distribution of $10,000 of his account, which had $2,000 of after-tax contributions and the remainder as pre-tax amounts, the participant could elect to rollover the entire $8,000 pre-tax amount to a traditional IRA and the remaining $2,000 to be paid in cash (or beginning in 2008, rolled to a Roth IRA) to the participant tax-free.

An updated model 402(f) (rollover notice) was issued in late 2009 (Notice 2009-68) that challenged this approach and the latest EP Newsletter (focusing on Roth conversions) appears to follow the same approach. The Notice states that if the distributee elects to rollover only a portion of the distribution in a direct rollover, an allocable portion of any after-tax contributions are considered rolled over. (A similar approach was taken for a partial direct rollover of Roth accounts -- an allocable portion of the earnings are considered rolled over.) More recently, the IRS issued its Spring 2010 newsletter that appears to take the same pro-rata allocation approach; unfortunately, it does not contain any examples to confirm the approach and by its terms is limited to conversions to Roth IRAs.

It appears that each rollover/cashout is being treated as a separate distribution (which is prior, under the Service's analysis, to the annuity starting date) and therefore subject to Code section 72(e)(8), which requires this pro rata allocation approach. Presumably, thereafter, the 402(c)(2) flush language -- that provides for the rollover of taxable amounts first -- can be applied. However, this language does not appear to have any impact on the payment that is directly rolled over.

This IRS approach appears to mirror the approach taken for Roth contributions under Treas. Reg. § 1.402A-1, Q&A-5, where (1) the regulations expressly limit the special ordering rule to indirect rollovers -- the part that is rolled over is deemed to consist first of the portion of the distribution that is attributable to income under section 72(e)(8), and (2) following the Preamble to TD 9324, treat the portion of the distribution that is rolled over as a separate distribution for purposes of applying Code section 402(c)(2). However, Roth accounts are different from after-tax amounts because Roth accounts are generally treated as a "separate

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account" for section 72 purposes, which would prohibit commingling earnings on Roth contributions with other taxable amounts.

Moreover, the clear language of Code section 402(c)(2), which expressly applies to direct rollovers, appears to trump the pro rata allocation rules, and the fact that a separate 1099-R may need to be filed for the rollover and the cashout (or for split distributions between IRAs), due to the box 7 coding provisions, should not alter this result. The legislative history, as noted above, also does not make this pro rata allocation point clear. And, there is no policy reason for providing for a different result depending solely on whether the amount is directly or indirectly rolled over, or whether the distribution is split between multiple IRAs.

To alter this long-standing result based on a single reference in the rollover notice (or a brief summary of the rules, without examples, in an IRS newsletter) is not sound tax administration. If the pro rata allocation method is required, Form 1099-R reporting and withholding violations and related penalties (and interest) may result in numerous cases. Moreover, this may result in improper rollover of after-tax amounts to qualified plans (either because the law prohibited roll over of after-tax amounts (pre-PPA, only certain DC plans were permitted to accept them) or because the plan terms prohibited acceptance of such amount), which will require corrective distributions from the impacted plans.

Prior to the issuance of the IRS newsletter, we had understood that Treasury officials were well aware of this issue and practitioners concerns and were looking to see if there was anything that they could do. Moreover, the newsletter was focused on Roth IRA conversions and did not include any examples.

Therefore, we continue to recommend a "wait and see" approach prior to making system/plan design changes. And we will continue to encourage the IRS and Treasury to reconsider their position and, in the event their position is firm, to issue prospective, binding authority that express addresses their position and makes it clear that prior transactions are not adversely affected.

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