Employee Benefits Corner

By Elizabeth Thomas Dold and David N. Levine

2010–A Look at the Upcoming Year

As 2010 approaches, there are a number of important developments and filing deadlines that sponsors of tax-qualified defined benefit and defined contributions plans should have on their radar. The year 2010 will bring (1) renewed interest in Roth IRA conversions, (2) a new model safe harbor rollover notice (often referred to as an "eligible rollover distribution notice" or a "402(f) notice"), and (3) several important deadlines for adopting the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) (hereinafter, EGTRRA) restatements and filing for determination letters with the IRS. Each of these developments is described below.

Roth IRA Conversions

Over the past 12 years, "Roth" after-tax contributions have expanded throughout many of the most popular retirement plan vehicles available under the Internal Revenue Code.

In 1998, many individuals have been taking advantage of Roth IRA to make after-tax contributions to IRAs that are, if certain requirements are met, not taxed again when distributed from the Roth IRA. In 2006, this after-tax Roth feature was extended to 401(k) and 403(b) plans. Roth 401(k) and 403(b) deferrals are subject to income and employment taxes when made, but if they are held in the 401(k) or 403(b) plan for a five-year holding period (and until age 59 1/2, the participant's death, or the participant's becoming disabled) then the earnings on these amounts are also tax-free

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when distributed. These Roth 401(k) and 403(b) accounts may also be rolled on a tax-free basis to another Roth 401(k) or 403(b) account or to a Roth IRA. Beginning in 2008, all tax-qualified, 403(b) and governmental 457(b) plans were required to permit non-Roth accounts to be rolled over (directly or indirectly) to a Roth IRA. Similar to Roth accounts in a qualified plan, if these amounts are held in the IRA for the five-year holding period and not distributed until reaching age 59 1/2, death or disability, all payments out of the IRA are tax-free. However, this conversion to a Roth IRA was limited by two important restrictions: no conversion was permitted if (1) the participant's adjusted gross income (AGI) exceeded $100,000, or (2) the participant filed a federal income tax return using a "married filing separately" tax status. These restrictions, along with the immediate taxation of the conversion amount (less any after-tax contributions rolled over) have limited the appeal of this rollover to Roth IRA feature.

Beginning in 2010, the Roth landscape will expand again. Effective January 1, 2010, the $100,000 AGI limit and the prohibition on conversion applicable to individuals who file their tax returns as "married filing separately" no longer apply. As a result, anyone can now convert a "traditional" IRA or a rollover distribution from a tax-qualified plan into a Roth IRA. Moreover, as further potential incentive, there is a special tax election available for 2010, which permits participants to spread the federal income tax liability for the conversion ratably over two years—2011 and 2012—with no immediate taxation for 2010. If the IRS adopts an approach similar to the approach used when Roth IRAs were first introduced, it is likely that this multi-year taxation election will be made on an individual's tax return (and plan sponsors will be able to report (and withhold, if offered) as if the distribution was taxable in 2010 on Form 1099-R).

There are a number of ways plan sponsors prepare for (or even facilitate) this significant change in the Roth IRA conversion rules:

- **In-Service Distribution Restrictions.** First, sponsors should review their in-service distribution rules, as a Roth conversion is only available to the extent that amounts are eligible to be distributed from a plan and that these amounts will qualify as an "eligible rollover distribution."
  - *Pension Plans.* For pension plans (including defined benefit plans and money purchase pension plans (which are defined contribution plans)), an age 62 in-service distribution right can be offered.
  - *Profit-Sharing Plans*. For profit-sharing plans, some employer matching and profit-sharing contributions can be distributed while the participant is still working, provided that the IRS rules that restrict the distribution of some amounts for as long as five years of service are satisfied.
  - *401(k) Plans*. For 401(k) plans, deferrals can be distributed in-service at age 59 1/2.
- **Investment Strategy.** Second, plan sponsors should consider the impact of such distributions on its investment strategy for the plan—including investment fees and available class grades, in the event that the employer anticipates a number of large account balances being rolled out of the plan. As the assets of defined contribution plans have grown, many plans have negotiated for access to lower-cost mutual fund, collective trust and separately managed account investment options. If a significant number of participants elect, either during their service or after termination, to withdraw their accounts, these arrangements may be affected. Lastly, if a plan is funded with annuity contracts, these contracts may also have withdrawal restrictions that need to be taken into account.
- **Plan Amendments.** Third, plan sponsors can amend their plans to expand the in-service distribution options. This amendment can by made by the end of the 2010 plan year and be retroactive as of any date within the plan year. Distribution forms and procedures will also likely need to be modified to reflect any new distribution options, and the option to roll to a Roth IRA.

Rollover Notice

For years, plan sponsors have been waiting for the IRS to provide an updated version of its model rollover notice. The last update of this notice was issued in 2002. However, since then many law changes have been enacted that modify these rules. In late 2009, the IRS issued this long-awaited update, which is effective for distributions beginning January 1, 2010. The update of the model notice uses a helpful question and answer format and has been updated for laws and guidance is-

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sued through September 28, 2009. Although a plan is not required to use the new model notice language, this newly issued language serves as a "safe harbor" for complying with the eligible rollover distribution notice rules. Further, even if the model notice is used, as noted below, a plan should exercise caution to ensure that the default model notice language accurately reflects the operation of the plan.

The new guidance makes a number of changes to the model notice, largely to reflect numerous statutory changes since 2002. Key provisions of the revised notice include the following:

- **Separate Notices.** There are now separate model notices for Roth and non-Roth accounts. Historically, these provisions have been contained in a single notice, but the notice expressly states that separate notices "should" be provided (and, in public informal comments, IRS and Treasury staff have informally "recommended" providing notices separately). As such, it is unclear if a single notice containing both pieces (either combined or separate) continues to satisfy the IRS "safe harbor" when distributed to all participants. Therefore, to the extent that the notices are combined, some sponsors are retaining, in large measure, the IRS model language in order to attempt to preserve safe harbor status.
- **Partial Direct Rollover.** The model notice language provides that if the distribute elects to rollover only a portion of the distribution in a direct rollover, that an allocable portion of any after-tax contributions are considered rolled over. Similarly, with a partial direct rollover of Roth accounts, an allocable portion of the earnings are considered rolled over. Historically, many plan sponsors have interpreted the Code to allow rollover of the pre-tax amounts first.
- **Rollover to a Roth IRA.** The model notice language explains a distributee's ability to make a rollover to a Roth IRA and the tax consequences of such a rollover, but fails to explain any applicable income tax withholding rules, including the IRS's informal position that any tax withholding amount may be subject to the 10-percent early withdrawal tax.
- **Ten-Percent Early Withdrawal Tax.** The model notice language expands the list of qualified plan distributions that are not subject to the 10-percent tax on early distributions to include (1) qualified reservist distributions; (2) health insurance distributions to certain qualified public safety employees under governmental pension plans; (3) withdrawals from an eligible contribution arrangement (414(w)) within 90 days after the date of the first elective contribution (which is inadvertently listed twice and also not eligible for rollover treatment); and (4) corrective distributions of contributions that exceed tax law limitations. It also separately explains the different exceptions for distributions from an IRA.
- **Thirty-Day Waiver Provision.** The prior model notice language explained that distributees have 30 days to consider whether or not to directly roll over their distributions from a plan. This provision was removed by the new model notice language, but this requirement has not changed and, accordingly, should be either added back to the notice or addressed in a separate notice or distribution request form.
- **Governmental Plans.** The model notice language explains that certain public safety officers may exclude from their income amounts paid directly to an accident or health plan as premiums, and a single paragraph replaces the prior, separate model notice for governmental 457 plans. Therefore, it appears that a separate governmental 457 plan notice may fall outside the safe harbor beginning January 1, 2010.
- **Automatic Rollover.** The model notice language explains that a mandatory cash-out of more than $1,000 (that does not exceed $5,000) will be rolled into an IRA, unless the distributee elects otherwise. This provision should be removed if a plan lowered its cash-out limit to $1,000. Moreover, the language also defines a mandatory cash-out, in part, as not exceeding $5,000 "(not including any amounts held under the plan as a result of a prior rollover made to the plan)." This exclusion of rollover contributions when applying the cash-out limit is an optional rule that some plans do not apply and may need to be deleted if not consistent with a plan's terms.
- **Sixty-Day Rollover Waiver.** The model notice language explains the availability of an IRS waiver of the 60-day rollover deadline in certain hardship circumstances.
- **Beneficiaries.** The model notice explains that surviving spouse beneficiaries may treat a roll-

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over IRA as their own or as an inherited IRA (and the related tax consequences), and explains that nonspouse designated beneficiaries may make a direct rollover to an inherited IRA only (which is not required for plans until January 1, 2010). As such, plans that introduce the new language prior to 2010 should ensure that they actually permit nonspouse rollovers at the time it is introduced. Further, the model notice language fails to explain the applicable withholding rules, and, notably, discussion of all the voluntary withholding rules has been removed.

- **Nonresident Aliens.** The model notice language explains, for the first time and only to a limited extent, the rollover and withholding rules applicable to nonresident aliens (*e.g.*, for U.S. source income, generally withhold 30 percent of the taxable payment).

As in the past, a plan administrator may delete information that does not apply to the plan and add information that does not conflict with the eligible rollover distribution notice requirements. Moreover, if relevant law is amended after September 28, 2009, the plan administrator must update the model notice in order to continue to comply with eligible rollover distribution notice requirements. There has historically been a tension between reliance on the model and going ahead and making statutory changes. Unfortunately, this new guidance does not provide any relief from the need to adopt ongoing updates to their notices. As such, plan administrators will continue to face such questions in 2010 as legislative and regulatory changes are adopted.

2010 Plan Law Changes

To date, there are only a few qualified plan law changes that will first go into effect in 2010:

- **Rollover by Non-Spouse Beneficiary.** As noted above, effective January 1, 2010, if a tax-qualified, 403(b), or governmental 457(b) plan does not yet permit a nonspouse beneficiary to receive a direct rollover to an inherited IRA, this feature must be added.
- **DB(k).** Effective for the 2010 Plan Year, plan sponsors can offer a new type of plan that combines a 401(k) feature with a defined benefit plan. Much like the delay in implementing Roth 401(k) and 403(b) contributions when plan sponsors were waiting for IRS guidance, adoption of these DB(k) plans will depend on further IRS guidance on implementation rules and requirements.

January 31, 2010, Deadline for Cycle D Filers

The deadline for filing an application for a determination letter on tax-qualified plans that fall inside "Cycle D" of the IRS' determination letter program is nearly here. Plan sponsors with a "4" or "9" as the last digit of their EIN that maintain an individually designed plan (*e.g.*, not a pre-approved plan), and "multiemployer plans" as defined in the Internal Revenue Code are part of the "Cycle D" determination letter filing period. Those plan sponsors and plans filing for a determination letter application in "Cycle D" should submit a determination letter application by January 31, 2010. Although a plan sponsor or a plan is not required to apply for a determination letter, it is regularly recommended because it allows plan sponsors to have the IRS review the form of their plan document (not actual operations) to ensure that it complies with applicable IRS rules and provides, in most cases, an ability to retroactively correct any failures in the form of their amendments to their plan document.

As part of the filing, the plan document should be updated to incorporate all prior EGTRRA changes, and include changes for the final Code Sec. 415 maximum benefit/maximum contribution regulations, the final Code Sec. 401(a)(9) required minimum distribution rules and the other items listed in the 2008 Cumulative List and contained in IRS Notice 2008-108.

Importantly, this January 31 deadline can be extended until January 31, 2011, if the plan sponsor has a plan year beginning on or after February 1 (*i.e.*, is not a calendar year plan). Further, plan sponsors with an EIN ending in "5" or "0" (or governmental plans that did not file in "Cycle C") should start to thing about filing for a determination letter, as applications can begin as early as February 1, 2010 (with a deadline of January 31, 2011).

April 30, 2010, Deadline for Pre-Approved Defined Contribution Plans

For plan sponsors that provide a defined contribution plan (*e.g.*, 401(k) plan) through a pre-approved plan

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(where the IRS has issued an advisory or opinion letter as to the form of the master and prototype or volume submitter plan), the new EGTRRA approved document must be adopted by April 30, 2010. If these plan sponsors wish to also obtain a determination letter on their plan, they should file a Form 5307 determination letter application with the IRS by that date. Plans that have converted from master and prototype or volume submitter status to an individually designed plan should also consider the need to file a Form 5300 determination letter application by that date.

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