

# retirement

## plan news

SEPTEMBER/OCTOBER 2007

### Final Roth Distribution Regulations

Created by the Economic Growth and Tax Relief Reconciliation Act of 2001, the Roth 401(k) was slated to start in 2006 and scheduled to disappear after 2010. However, the Pension Protection Act of 2006 (PPA) eliminates the sunset provision for the designated Roth 401(k), making it a permanent plan option.

On April 27, 2007, the IRS issued final regulations for designated Roth 401(k) and 403(b) distributions. Effective April 30, 2007, the regulations are applicable to taxable years beginning on or after January 1, 2007 (except for the separate accounting rules, which were applicable January 1, 2006). Here is a recap of some key points.

**Distribution to an Alternate Payee or Beneficiary.** The final regulations clarify that the same factors used to determine whether a participant distribution is qualified (i.e., the completion of five years since the first designated Roth contribution and the attainment of age 59½, disability, or death) are to be used when the distribution is going to an alternate payee or beneficiary. This means that the participant's age and service characteristics are used rather than the beneficiary's. An exception is provided if the alternate payee or surviving spouse is rolling over the distribution into a designated Roth account under a plan sponsored by his or her employer.

**Separate Accounting Requirement.** Amounts in a participant's Roth account must be kept separate from amounts in the same participant's pretax account and from all other sources from the time of the first Roth deposit to the final Roth distribution. According to the IRS, "Any transaction or accounting methodology that has the effect of directly or

indirectly transferring value from another account under the employer's plan or plans into the designated Roth account of an employee will violate the separate accounting requirements of section 402A."

**Cash-out and Automatic Rollover Rules.** The final regulations confirm that the involuntary cash-out and automatic rollover rules will be applied separately to designated Roth contributions (apart from all other plan contributions). Thus, when applying the threshold amounts for cashouts or automatic rollovers, Roth and non-Roth amounts must be disaggregated.

**Taxation of Nonqualified Distributions.** Nonqualified distributions of designated Roth accounts must be made pro rata from earnings and contributions. Roth deferrals, like pretax deferrals, may be distributed to an employed participant only after he or she attains age 59½ or has a financial hardship.

**Hardship Distributions.** The final regulations clarify that if a participant has



both pretax and Roth deferrals, the hardship distribution may be calculated on the aggregate, but the actual distribution may be limited to pretax deferrals.

In general, earnings may not be included in hardship distributions of elective deferrals (unless earned prior to 1989).

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# Final Roth Distribution Regulations (Continued from page 1)

However, an unqualified Roth hardship distribution must include a pro rata distribution of earnings and Roth deferrals.

**Example 1:** Bill has a designated Roth account of \$15,000 (\$10,000 in deferrals and \$5,000 in earnings). The hardship distribution is limited to the deferral amount, i.e., \$10,000. If Bill takes the entire \$10,000, \$6,666.67 (66.67%) is the after-tax Roth deferral amount and \$3,333.33 (33.33%) is the amount of taxable earnings.

If Bill needs a second hardship distribution three years from now, the calculation is treated as if the first distribution of \$10,000 was entirely from deferrals. If Bill's lifetime contributions total \$14,000 in deferrals, the \$10,000 withdrawn as the first hardship would be subtracted from the amount available for the second hardship withdrawal. This could be confusing because Bill was taxed as though only \$6,666.67 of the first distribution came from Roth deferrals.

**Example 2:** Ron has \$10,000 in a pretax deferral account and \$10,000 in his designated Roth account (with \$7,000 in deferrals and \$3,000 in earnings in each). Ron could take a hardship distribution of up to \$14,000. If he takes a \$7,000 hardship distribution from his pretax deferrals, it would result in a taxable distribution of \$7,000.

However, if Ron takes a \$7,000 withdrawal from his Roth account and the distribution is unqualified, it would be distributed on a pro rata basis: \$4,900 (70%) in after-tax Roth deferrals and \$2,100 (30%) in taxable earnings. If Ron requested a second hardship later, the \$7,000 distribution already taken would be subtracted from the total deferrals available for hardship, even though it would appear that only \$4,900 in Roth deferrals was previously taken.

Plans may want to limit hardship distributions to pretax deferrals. Distribution amounts would be based on the total of pretax and Roth deferrals, but the amounts distributed would be limited to pretax deferrals only. This would help preserve the purpose of the designated Roth account (i.e., tax-free earnings for participants).

**Distribution of Excess Deferrals.** If excess Roth deferrals are returned to a participant by April 15 of the year after deferral, no adverse tax consequences will result. If they are returned *after* that deadline, the excess Roth contributions will be included in the participant's gross income for the year deferred and in the year of distribution. This is the only time Roth deferrals are taxed when distributed.

**Rollovers.** Here are some of the rules governing Roth rollovers.

**After-tax Amounts.** Under the final regs, after-tax amounts in a designated Roth account may be moved to another employer's designated Roth account *only* by direct rollover, never by participant rollover.

### **Separate Accounting for Direct**

**Rollovers.** Any amount that is directly rolled over from one designated Roth account to another designated Roth account is subject to the separate accounting requirements of the new plan.

### **Rollovers Between Roth 401(k)s and Roth 403(b)s.**

The final regulations permit a designated Roth 401(k) to be directly rolled over to a designated Roth 403(b) and vice versa. This change was due to the passage of the PPA.

**Participant Rollover to a Designated Roth Account.** When a distribution from a designated Roth account is paid to the participant, the participant may roll over *only* the taxable portion of the distribution (i.e., the earnings) to another designated Roth account. (There is a 60-day time limit.) The five-year tracking period is *not* carried over from the distributing plan (see page three article), and the recipient plan must have separate accounting for designated Roth amounts.

### **Participant Rollover to a Roth IRA.**

Any or all of a designated Roth distribution paid to a participant may be rolled over to a Roth IRA within 60 days. However, if only part of the distribution is rolled over, the pretax portion (i.e., the earnings) must be rolled over first. The income limits that apply to ordinary Roth IRA contributions do not apply to a rollover from a designated Roth 401(k) or 403(b) to a Roth IRA.

**Amounts That Are Not Qualified Distributions.** Distributions of excess deferrals, excess contributions, and excess aggregate contributions can never achieve qualified distribution status and are not eligible for rollover. ❖



# Final Roth Tracking Period and Reporting Rules

The five-taxable-year period (required for qualified Roth distributions) begins on the first day of the taxable year during which an employee first makes a designated Roth contribution to the plan and ends when the fifth consecutive taxable year is completed thereafter. Rollovers affect the five-year tracking period. Here are the final Roth 401(k) regulations for tracking the five-year period for rollovers and the related reporting requirements.

**Direct Plan-to-plan Rollover.** If there is a direct rollover from one designated Roth account to another, the five-year tracking period for the recipient plan begins on the first day of the taxable year during which the employee first made designated Roth contributions to the former plan or to the recipient plan, whichever is earlier.

**Example:** A participant first makes contributions to a designated Roth account in Plan A in 2006 and later changes jobs. The Plan A account is directly rolled over to a designated Roth account in Plan B under a new employer in 2009. The participant first contributes to Plan B in 2009. The five-year period for Plan B starts as of 2006 rather than 2009.

**Direct Rollover to a Roth IRA.** When an unqualified distribution from a designated Roth account is directly rolled into a Roth IRA, the amount of time the funds were in the designated Roth account does not count toward the five-year period of the Roth IRA. *However*, if the Roth IRA was established *before* the rollover occurred, then the five-year period of the Roth IRA applies to the designated Roth rollover funds.

When a qualified distribution is rolled into a Roth IRA, the entire amount is treated as basis, which means the amount is not taxable. A subsequent distribution of the rollover amount can be withdrawn tax free, regardless of the status of the Roth IRA's five-year tracking period. However, the earnings on the designated Roth rollover that accrue in the Roth IRA will only be tax free if the Roth IRA satisfies the five-year requirement.

**Tracking Period for Reemployed Veterans.** Reemployed veterans are permitted to make Roth contributions for the time they were in service (provided the plan permitted Roth contributions during those years). The final rules clarify that,

for purposes of tracking the Roth five-year period, the “first year” is the plan year a reemployed veteran designates for his or her contributions. (This is done in order to receive applicable matching contributions.)

If no such designation is made, Roth contributions are treated as having been first made in the *later of* the first taxable year in which the veteran's qualified military service began or the first taxable year in which designated Roth contributions could be made under the plan.

**Direct Rollover Reporting Requirements.** The distributing plan administrator is responsible for tracking the five-year period and providing the recipient plan administrator with a statement within 30 days of the direct rollover. The statement must indicate either: the first year of the five-taxable-year period and the portion of the distribution that represents designated Roth contributions, or that the distribution is qualified.

**Participant Rollover Reporting Requirements.** The distributing plan administrator must provide the participant with the same information as above (except for the first year of the five-year period) within 30 days of the participant's request for such report. This requirement may be satisfied by including the relevant information on a statement attached to the check issued to the employee.

The recipient plan administrator must provide the IRS with a new report acknowledging that the participant rollover contribution has been accepted. The IRS will be issuing instructions for this form. *However, until the relevant forms and instructions are issued, no reporting is required.* ❖



# recent developments

■ **DB Plan In-service Distributions at Normal Retirement Age.** The IRS has issued regulations permitting distributions from a pension plan to a participant who reaches “normal retirement age” prior to ending his or her employment with the plan sponsor. Historically, in-service distributions have been prohibited in defined benefit plans. However, participants have been allowed to take in-service distributions if they deferred actual retirement and worked past their normal retirement age. The issue then became: What is an “appropriate” normal retirement age?

The IRS guidance makes it clear that a normal retirement age of 62 or higher would never be deemed unreasonable. In industry conversations, IRS officials have made it clear that a normal retirement age of 55 or higher would not be

questioned unless it was clearly not reasonable based on the employer’s facts and circumstances.

**Note:** These rules should be distinguished from the guidance on phased retirement that would allow in-service distributions even before normal retirement age.

■ **Nonspouse Beneficiary Rollover Rules.** The deadline for a nonspouse beneficiary to choose the life expectancy method of receiving benefit payments is the end of the year after the participant’s year of death. So, the nonspouse beneficiary of a participant who died in 2006 has only until the end of 2007 to choose this method.

If the nonspouse beneficiary of a participant who died prior to 2006 is

taking distributions under the life expectancy rules, the beneficiary may directly roll over the amount remaining in the account, less the required minimum distribution (RMD) for the year of the rollover, to an inherited IRA if the plan permits such rollovers.

If the nonspouse beneficiary of a participant who died in 2004, 2005, or 2006 is taking distributions under the five-year rule, he or she may directly roll over the remaining amount to an inherited IRA (plan permitting) and continue the five-year rule. Such rollovers may only be made in the first four years after the participant’s death and not in the fifth year when all the assets must be distributed. ❖

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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