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Pension ANALYST

Important Information | Plan Administration and Operation | September 2007

IRS Issues Final Roth 401(k) Distribution Rules

WHO'S AFFECTED This information applies to sponsors of and participants in 401(k) plans, including multiemployer plans, governmental plans, and non-electing church plans.

BACKGROUND AND SUMMARY On April 30, 2007, the Internal Revenue Service issued final rules providing comprehensive guidance on the taxation, rollover, and reporting of distributions from designated Roth accounts in 401(k) plans. These rules generally follow the proposed rules from January 26, 2006, with a few modifications.

In addition, these rules made changes to other regulations affecting Roth deferral contributions, and provide some modifications to the January 3, 2006, final Roth regulations regarding contributions.

This *Pension Analyst* summarizes some of the changes and clarifications made to the prior Roth guidance.

ACTION AND NEXT STEPS Plan sponsors that are interested in adding a Roth feature should review these rules carefully and consult with their Prudential Retirement representative. Plan sponsors that have already added a Roth feature should review these rules to determine if any changes to plan administration or plan documents are necessary.

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Background

The Economic Growth and Tax Relief Reconciliation Act of 2001 authorized the establishment of Roth 401(k) accounts beginning January 1, 2006. On December 30, 2005, the IRS issued final rules regarding Roth 401(k) accounts. However, those rules did not address distribution and taxation issues. On January 26, 2006, the IRS issued proposed rules to provide guidance on the distribution and taxation issues. On April 30, 2007, the IRS issued final rules to provide comprehensive guidance on the taxation, rollover, and reporting of distributions from Roth deferral accounts.

Plans may allow an employee who makes elective deferral contributions to irrevocably designate some or all of their future deferral contributions as Roth contributions. Unlike "traditional" deferral contributions, which are not subject to federal income tax when they are contributed to the plan, Roth deferral contributions are included in the employee's current taxable income. If certain conditions are met, these contributions, along with related earnings, are not taxable when distributed.

Roth deferral contributions must satisfy the rules that apply to pre-tax deferral contributions, such as 100% vesting and the distribution restrictions. Plans must recordkeep Roth 401(k) contributions and earnings in a separate account and may not allow a participant to transfer money between the pre-tax and Roth sources.

A single deferral limit and catch-up limit apply to the combined total of an employee's Roth and pre-tax contributions. Roth deferral contributions are subject to the minimum required distribution rules in the same manner as pre-tax contributions, even though Roth IRA accounts are not subject to these rules. Roth deferral contributions are also included in the actual deferral percentage test (ADP test), as applicable, in the same manner as pre-tax contributions.

Determination of Five-Year Period for Qualified Distributions

Qualified distributions of Roth deferral contributions and earnings are not taxable. A distribution is a "qualified distribution" if it satisfies two conditions:

1. It is made on or after the date the employee reaches age 59½, dies, or becomes disabled; and
2. The "five-year participation rule" has been satisfied.

The five-year participation period for a participant begins on the first day of the first taxable year in which the participant made Roth deferral contributions to the plan and ends when five consecutive taxable years have been completed.

The final rules 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. However, if an alternate payee or a spousal beneficiary rolls the distribution into a designated Roth account in his own plan, the alternate payee's or spouse's age, disability, or death is then used to determine whether a distribution from the receiving plan is qualified.

Roth deferral contributions made by a reemployed veteran are treated as made in the tax year to which the contributions related. Reemployed veterans may identify the year for which a contribution relates for other purposes, and the treatment for the five-year period follows that identification. If the employee does not identify the year to which the contribution relates, the plan may treat the contribution as being made for the later of:

- The veteran's first taxable year in which his qualified military service began; or
- The first taxable year Roth contributions could be made to the plan.

In addition, the final rules provide that a distribution is "qualified" based on the actual year the payment is made from the participant's account. As a result, installment and annuity payments made after the five-year participation period is satisfied are qualified, even if earlier payments were made before the end of the five-year period. *For example, Justin makes his first Roth contribution in 2007. In 2011, he retires at age 65 and requests installment distributions over a period of 15 years. The installment made in 2011 is not a qualified distribution, since the 5-year participation period has not been met. The installments for 2012 and later years are qualified.*

Likewise, a payment that is attributable to a prior calendar year (such as for a participant's first minimum required distribution) is treated as a qualified distribution if it is actually made after the five-year participation period is satisfied. *For example, Joan makes her first Roth contribution in 2011. She turns 70½ in 2015. Her 2015 minimum required distribution does not need to be distributed until April 1, 2016, and is paid on March 15, 2016. The MRD is qualified since five years have passed since Joan made her first Roth contribution and she is over age 59½.*

Rollover of Designated Roth Contributions

In order for a participant to roll over the nontaxable portion of a Roth deferral account (i.e., either the full amount of a qualified distribution, or the after-tax contribution portion of a nonqualified distribution) to another Roth deferral account, the rollover must be a direct rollover. Under the proposed rules, this portion of a Roth 401(k) distribution could not be rolled into a Roth 403(b) arrangement. The final rules, however, reflect the Pension Protection Act of 2006 (PPA) provision that allows after-tax contributions to be directly rolled over from a qualified retirement plan to another qualified retirement plan or to a 403(b) arrangement. Therefore, the portion of a Roth 401(k) distribution may be directly rolled into a Roth 401(k) plan, a Roth 403(b) arrangement, or Roth IRA. Similarly, the nontaxable portion of a Roth 403(b) distribution may be directly rolled into a Roth 403(b) arrangement, Roth 401(k) plan, or Roth IRA.

The final rules also clarify that a distribution from a designated Roth account may only be rolled over to a 401(k) plan or 403(b) arrangement that offers a Roth feature.

Under the proposed rules, a participant could indirectly roll over the taxable portion of a distribution to another Roth deferral account within a 60-day period. However, the five-year participation period under the distributing plan did not carry to the receiving plan. The final rules retain this restriction, but clarify that if the participant is rolling over to a plan in which the participant already has a pre-existing Roth deferral account with a longer period of participation, the start date of the pre-existing Roth account is used for the participant's five-year participation period.

Spousal beneficiaries may roll over Roth deferral accounts into their own Roth deferral accounts or to Roth IRAs. Non-spousal beneficiaries may not roll over Roth deferral accounts.

Rollovers from Roth 401(k) to Roth IRA

Beginning in 2008, PPA permits a participant to directly roll over his "eligible rollover distributions" from a qualified plan, 403(b) arrangement, or section 457(b) plan into a Roth IRA, as long as the participant's adjusted gross income (AGI) is $100,000 or less. While this provision succeeded in removing many of the barriers for rolling dollars to a Roth IRA, it appears to have inadvertently created a new restriction. The PPA amendment does not include an exclusion from the AGI limitation for Roth 401(k) accounts. Therefore, until Congress takes action to correct the issue, participants with an AGI of over $100,000 may be restricted from rolling over Roth deferral amounts to a Roth IRA, even though the final Roth IRA rules state the income restriction does not apply.

The Tax Increase Prevention and Reconciliation Act (TIPRA) repeals the $100,000 threshold beginning in 2010, allowing all taxpayers to make direct rollovers from an eligible retirement plan to a Roth IRA. However, for 2008 and 2009 taxable years, participants affected by this provision may decide to leave the money in the Roth 401(k) until 2010, as permitted by the plan.

Rollover Reporting

If the taxable portion of a Roth deferral account is *indirectly* rolled over into another Roth deferral account within 60 days, the plan administrator of the *receiving* plan must report information regarding the rollover contribution to the IRS by the due date for filing Form 1099-R. The final rules provide relief from this reporting requirement until relevant Forms and Instructions are released.

Hardship Withdrawals and Minimum Required Distributions (MRDs)

The final rules clarify that hardship withdrawals and MRDs may be “qualified distributions,” to the extent they otherwise satisfy the requirements to be qualified.

Excess Deferrals

Although Roth deferral contributions are not excluded from a participant’s taxable income when contributed to the plan, they are treated as elective deferrals for purposes of the elective deferral limit ($15,500 for 2007). If elective deferrals exceed the limit for the year, the excess can be distributed by April 15 of the year following the year of the excess without adverse tax consequences. However, if excess deferrals are not distributed by April 15 of the year following the year of the excess, the Roth portion of the distribution (basis and earnings) attributable to an excess deferral is includible in income, and is not eligible for rollover.

Gap Period Income for Excess Deferrals

The final rules retain the proposed requirement that any distribution of excess deferrals include gap period income. This gap period income rule applies to both pre-tax and Roth deferrals and will continue to apply even after the 2008 elimination by PPA of the gap period income rule that applies to ADP and ACP test corrective distributions.

This rule applies to excess deferrals for tax years beginning on or after 2007, which will generally be distributed on or after January 1, 2008. Plan amendments necessary to include gap period income on excess deferrals generally must be adopted by the later of:

- The due date, including extensions, for filing the employer’s tax return for the 2007 tax year; or
- The last day of the 2007 plan year.

The amendment deadline for a single-employer governmental plan is the later of the deadline described above or the last day of the next legislative session held following the effective date of the regulations.

The amendment deadline for a single-employer plan maintained by a tax-exempt employer (including a nonelecting church plan) is based on the deadline for filing the employer’s Form 990.

A multiple employer plan or multiemployer plan must be amended by the last day of the tenth month following the last day of the plan year that includes the effective date of these rules.

Modifications to 2006 Final Roth Rules

In response to comments received by the IRS, the final rules provide that the balance of a participant's Roth deferral account and his other contributions under a plan are treated as being held under two separate plans for purposes of applying the automatic rollover rules.

For example, Jason has $700 in Roth contributions and earnings, and $800 in non-Roth contributions and earnings in his account, with a total account balance of $1500. The plan can subject the total account to the automatic cash-out rule, rather than require an automatic rollover, even though the participant's total account balance exceeds $1,000.

The final rules also confirm that catch-up contributions may be either pre-tax deferrals or Roth deferrals.

Effective Date and Next Steps

These rules are effective April 30, 2007, and generally apply to tax years beginning on or after January 1, 2007. However, certain provisions are effective for tax years beginning on or after January 1, 2006. These include:

- Rules for excess deferrals;
- Rules for rollovers to Roth IRAs;
- Rules preventing transfers of value between designated Roth amounts and non-Roth amounts.

A plan sponsor has until the end of the plan year in which the Roth feature is effective to adopt a Roth amendment. Plan sponsors interested in adopting a Roth feature should consult with their Prudential Retirement representative.

Designated Roth Account Rollover Chart

Type of Distribution	Type of Rollover Permitted	To	Affect on 5-Year Participation Requirement
Nontaxable Roth 401(k) • Qualified Distribution • Basis in Nonqualified Distribution	Direct	• Roth 401(k), or • Roth 403(b)*	Carries Over
	• Direct, or • 60-Day	Roth IRA	Does Not Carry Over
Taxable Roth 401(k) • Earnings Portion of Nonqualified Distribution	• Direct, or • 60-Day	• Roth 401(k) • Roth 403(b), or • Roth IRA	Carries Over *Only* if Direct Rollover to Roth 401(k) or Roth 403(b)
Nontaxable Roth 403(b) • Qualified Distribution • Basis in Nonqualified Distribution	Direct	• Roth 403(b), or • Roth 401(k)*	Carries Over
	• Direct, or • 60-Day	Roth IRA	Does Not Carry Over
Taxable Roth 403(b) • Earnings Portion of Nonqualified Distribution	• Direct, or • 60-Day	• Roth 403(b), • Roth 401(k), or • Roth IRA	Carries Over *Only* if Direct Rollover to Roth 403(b) or Roth 401(k)
Roth IRA	• 60-Day, or • Transfer	Roth IRA	Carries Over

*Represents a change from proposed rules.

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