



Analysis of
U.S. Treasury Department and Internal Revenue Service
Proposed Regulations on Designated Roth Accounts
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The Internal Revenue Service and the U.S. Treasury Department (hereinafter collectively referred to as Treasury) has proposed regulations relating to taxation of distributions from designated Roth accounts. The proposed regulations supplement the guidance already provided through Treasury's release of final Roth 401(k) regulations and IRS's publication of Frequently Asked Questions.

Designated Roth contributions, which are elective contributions that are included in gross income, were authorized in the Economic Growth and Tax Relief Reconciliation Act of 2001 also known as EGTRRA, but with a delayed effective date of January 1, 2006. A subsequent distribution of the contributions is excludable from gross income (along with the earnings on the contributions if the distribution is a qualified distribution). The proposed regulations are expected to be generally effective January 1, 2007, but with some recordkeeping requirements applicable during 2006.

Listed below are some of the key points addressed in the proposed regulations.

Rollover from Roth 401(k)/403(b) to a Roth 401(k)/403(b)

- Rollovers that include tax-free amounts must be accomplished through a direct rollover
- Distributing plan is required to report the amount of employee contributions and the first year of the five-taxable year period to the recipient plan, or that the distribution is a qualified distribution¹
- For purposes of potential qualified distributions, the five-taxable-year period begins on the first day of the employee's taxable year for which the employee first made designated Roth contributions to either plan

60-Day Rollover of Designated Roth Contributions

¹ Distributions generally are qualified if made after a five-taxable year period (which begins on the first day of the taxable year in which the first Roth contribution is made) provided the participant has attained age 59-1/2, or the distribution is on account of the disability or death of the participant.

- If distribution is made directly to the employee, the employee can roll over part or all of the distribution (contributions plus earnings) to an IRA; if only a portion is rolled over, the rolled over amount is treated as consisting first of taxable earnings²
- The employee can also roll over the taxable amounts within 60 days to another 401(k) plan or 403(b) plan; in this case, the employee's participation period in the original plan is not carried over and the recipient plan has reporting requirements
- Upon request of the employee, the distributing plan must provide a statement indicating the portion of the distribution attributable to basis (employee contributions) or that the distribution is a qualified distribution
 - Statement must be provided within 30 days of request
 - Statement does not need to indicate the first year of the 5-taxable-year period

Roth 403(b)

- Proposed rules generally incorporate basic and definitional rules for a designated Roth program in the final Roth 401(k) regulations and the taxation rules in the proposed regulations into the 2004 proposed Code Section 403(b) regulations, and provides clarification on how the taxation rules would apply to a 403(b) plan

Rollover from Roth 401(k)/403(b) to a Roth IRA

- Period that rolled over funds were in the Roth 401(k)/403(b) account does not count for the five-taxable-year period for determining qualified distributions from the Roth IRA
- If the employee had previously established a Roth IRA, the beginning of the five-taxable year period for determining qualified distributions from a Roth IRA (including a distribution attributable to the rollover) is the first of the taxable year for which a Roth IRA contribution was first made
 - This means that an employee that has maintained a Roth IRA for five years or more will be able to roll over a recently established Roth 401(k) or 403(b) account to a Roth IRA and immediately take a qualified distribution, provided the employee has attained age 59-1/2 or is disabled
- For a rollover of a nonqualified distribution, the nontaxable portion is treated as basis in the Roth IRA
- For a rollover of a qualified distribution, the entire amount of the distribution will be treated as basis in the Roth IRA

² Actually, the preamble states the opposite but the regulations and, more importantly, a relevant example in the regulations, make clear it is the intent to treat a partial rollover as coming first from the taxable portion. Language in the preamble likely resulted from a typographical error.

Rollover from Roth IRA to Roth 401(k)/403(b)

- Cannot be done

Distributions that Cannot Be Qualified Distributions

- Distributions caused by exceeding the statutory limit in Code Section 415
- Distributions caused by exceeding the statutory limit in 402(g)
 - If the distribution is made after April 15 of the year following the year in which the excess elective deferrals are made, the entire amount is taxable (with no exclusion for basis), and any distributions from the Roth account made in that year are treated as distributions of excess deferrals and earnings until all excess deferrals and attributable earnings are distributed
- Distributions needed to pass non-discrimination testing (excess contributions or excess aggregate contributions)
- Deemed distributions under Code Section 72(p) for failing to make payments on a loan
- Dividends paid on employer stock which are paid out of the plan under the provisions of Code Section 404(k) (if dividends are reinvested in the plan, then a distribution of the reinvested amount can be a qualified distribution)

Distribution of Employer Securities

- If a qualified distribution includes employer securities, the basis of each security is the fair market value on the date of the distribution and post-distribution appreciation will be taxed upon sale
- If a nonqualified distribution includes employer securities, normal net unrealized appreciation rules under Code Section 402(e)(4) will apply except that the designated Roth account will be treated as a separate contract

Hardship Distributions

- Plans must separately determine the amount of elective deferrals available for hardship and the amount of Roth contributions for tax purposes because hardship distributions are still generally limited to the principal amount of elective pre-tax and Roth deferrals (minus previous hardship distributions) but a distribution from the Roth account must include a pro-rata portion of the earnings for tax purposes