October 26, 2009

Via Electronic Delivery

Andrew E. Zuckerman
Director, Rulings and Agreements, Employee Plans

Alan N. Tawshunsky
Deputy Associate Chief Counsel (Employee Benefits)

Re: Interpretive Issue under Notice 2009-68 – Partial Rollovers

Dear Sirs:

The American Benefits Council (Council) is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

The Council is writing to urge the Internal Revenue Service to clarify the treatment of a partial rollover to an IRA of a distribution from a tax-preferred employer plan that includes after-tax contributions. Notice 2009-68, which was published on September 4, 2009, updates the safe harbor "402(f) notice," which describes the tax rules applicable to eligible rollover distributions from employer plans. The updated 402(f) notice includes a description of the tax rules applicable to plan distributions that include after-tax contributions. The description suggests for the first time a distinction in the tax treatment of partial rollovers that turns on whether the rollover is accomplished as a 60-day rollover or a direct rollover. The Council believes that there is no such distinction and urges the Service to clarify the matter.

Prior to enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), after-tax contributions could not be rolled over from an employer plan to an IRA. However, EGTRRA amended section 402(c)(2) to provide that after-tax contributions may be rolled over from an employer plan to an IRA. EGTRRA did not

include special rules on the allocation of after-tax amounts and pre-tax earnings. However, under the general rules of section 72, a portion of each distribution is treated as a recovery of the after-tax contributions. The portion is determined based on the ratio of the total after-tax employee contributions to the value of the account (usually called the pro rata rule). Under the pro rata rule, for example, if a participant had $40 of after-tax contributions and $60 of earnings, 40 percent of any distribution would be treated as a non-taxable recovery of after-tax contributions (assuming the $100 is part of a separate section 72 contract).

The Job Creation and Worker Assistance Act of 2002 (JCWAA) included a clarifying amendment to the rollover provision for after-tax contributions which added flush language to section 402(c)(2). The flush language states that, in the case of a rollover to an IRA, the "amount transferred shall be treated as consisting first of the portion of such distribution that is includible in gross income." To pick up on the example above, as a result of the flush language, if a participant has $40 of after-tax contributions and $60 of earnings, the participant could roll $60 to an IRA and retain $40, thereby rolling all of the taxable earnings to the IRA while retaining the $40 in non-taxable after-tax contributions.

The portion of the new 402(f) notice that deals with payments that include after-tax contributions describes the after-tax rollover rules as follows:

> If you do a direct rollover of only a portion of the amount paid from the Plan and a portion is paid to you, each of the payments will include an allocable portion of the after-tax contributions. If you do a 60-day rollover to an IRA of only a portion of the payment made to you, the after-tax contributions are treated as rolled over last. For example, assume you are receiving a complete distribution of your benefit which totals $12,000, of which $2,000 is after-tax contributions. In this case, if you roll over $10,000 to an IRA in a 60-day rollover, no amount is taxable because the $2,000 amount not rolled over is treated as being after-tax contributions.

The updated 402(f) notice appears to draw a distinction between rollovers that are accomplished through a 60-day rollover and a direct rollover. The distinction suggests that the flush language in section 402(c)(2) does not apply to direct rollovers. If, for example, a participant were to receive a cash distribution of $100 that includes $40 of after-tax contributions and $60 of earnings, the first $60 rolled to an IRA would be treated as pre-tax dollars. In contrast, however, if a participant went to a plan and indicated that he wanted a $100 distribution with $40 paid in cash and $60 paid in a direct rollover, the updated notice suggests that the tax consequences would be very different. Instead, a portion of the direct payment and a portion of the direct rollover would include after-tax contributions. Thus, it appears that the participant would have

$24 of income allocable to the direct payment (60% of $40) simply because the rollover was done as a direct, rather than 60-day, rollover.

In our experience, the interpretation reflected in the 402(f) notice is inconsistent with prevailing practice. This interpretation could have adverse tax consequences for individuals that have received distributions as well as for payors which have income tax withholding obligations. Apart from past compliance issues, the cost of changing and revising recordkeeping systems and administrative procedures to conform to this interpretation would be significant and sufficient time would need to be provided in order to implement the changes.

In addition, the Council believes that the interpretation suggested by the new 402(f) notice is incorrect. First, there is no statutory basis in section 402(c)(2) or any other provision of the Internal Revenue Code for distinguishing between direct and indirect rollovers in this manner. In addition, the Joint Committee on Taxation's explanation of the JCWAA (the Bluebook) strongly suggests that the flush language was meant to apply equally to both 60-day and direct rollovers.[1] Second, such an approach elevates form over substance since the two transactions described above are economically equivalent but would be accorded dramatically different federal income tax treatment. This has the related consequence of creating a trap for the unwary. Third, the approach described in the 402(f) notice would impose significant burdens on participants attempting to roll over only the portion of a distribution that is taxable. A 60-day rollover involves mandatory 20% withholding so that a participant would have to make up the amount withheld in order to effectuate the rollover.

We also note that the interpretation reflected in the notice appears to undermine rollovers of after-tax contributions from one employer plan to another. The updated 402(f) notice does not address the tracking of after-tax contributions in rollovers between plans, but the flush language in section 402(c)(2) is equally applicable to rollovers between plans and presumably the discussion in the notice on basis recovery in rollovers to IRAs is equally applicable to rollovers to employer plans. This would mean that all direct rollovers of amounts attributable to after-tax contributions includes some after-tax dollars since the pro rata rule, rather than the flush language in section 402(c)(2), would be applicable. Many employer plans, however, do not accept rollovers of after-tax contributions.

The most plausible explanation for the interpretation in the new 402(f) notice is that it treats the receipt of cash coupled with a direct rollover as two distributions, rather than one. The Council agrees that if a participant, for example, elects a direct rollover in January and a cash distribution in June, each separate distribution would include a proportionate return of after-tax employee contributions. However, it makes little sense

[1] STAFF OF JT. COMM. ON TAX'N, 107TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS, at 273 (2003).

to treat two payments as two separate distributions where the request is submitted as part of a single distribution request. It is very common for a participant to request a distribution from a plan and specify that one portion should be paid in cash and the other portion should be rolled over to an IRA. The request is clearly part of a unitary plan of distribution and most recordkeepers have treated the two payments as part of a single distribution. This clearly reflects the intent of the participant and is consistent with the manner in which typical distribution requests are made. Furthermore, the statutory language deals with a rollover of a "portion" of a distribution, strongly suggesting that a partial rollover coupled with a cash payment is a single distribution for tax purposes.[2]

In short, we urge the Service to clarify the applicable tax rules quickly since many plans will begin using the notice on January 1. Such a clarification could come in the form of a technical correction to the notice. If you have any questions about these comments, please contact Jan Jacobson, the Council's senior counsel, retirement policy, at 202-289-6700.

Sincerely,

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Senior Counsel, Retirement Policy
American Benefits Council

cc: George H. Bostick
Michael P. Brewer
Martin L. Pippins

[2] Existing guidance is not a model of clarity on when two payments are treated as one or two distributions. *Compare* Treas. Reg. § 1.401(a)(31)-1, Q&A-9 (treating partial rollover with a cash payment as a single distribution) *with* Treas. Reg. § 1.401(a)(31), Q&A-10 (characterizing two direct rollovers made as part of a single distribution request as two distributions). The Roth distribution regulations explicitly state that a direct rollover is treated as a separate distribution from an amount paid directly to an employee. Treas. Reg. § 1.402A-1, Q&A-5(a). However, the Roth regulations do not discuss the basis recovery rules. Moreover, the regulations also treat two payments – rollover and cash -- as a single distribution in other respects. *Id*.