



AMERICAN BENEFITS

COUNCIL

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VIA ELECTRONIC FILING

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Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Proposed Regulations on Designated Roth Accounts under Section 402A

Dear Sir or Madam:

The American Benefits Council (Council) appreciates the opportunity to comment on the proposed regulations on designated Roth accounts under Section 402A of the Internal Revenue Code. The addition of Roth contributions to plans is a significant change for 401(k) and 403(b) plans and the Council commends the Department of Treasury and Internal Revenue Service (collectively referred to as "Treasury") for addressing many complex issues in the proposed rule.

The 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 addition of designated Roth accounts to plans raises many issues and questions for plan sponsors and the Council respectfully requests that Treasury hold a hearing on the proposed regulations and that the Council be permitted to testify.

Plan sponsors implementing (or deciding whether to implement) designated Roth contributions were pleased that many of their questions were answered by the final regulations, published questions and answers and these proposed regulations. However, the Council requests additional clarifications in the areas discussed below.

Separate Accounts

The final regulations published December 30, 2005, clearly indicate that designated Roth contributions must have separate accounting from other contributions (Treas. Reg. Section 1.401(k)-1(f)(2)). The Council seeks clarification of the extent of this separate accounting rule including the interaction of this separate accounting treatment with several other rules presented in the proposed or final regulations.

Automatic rollovers and \$200 rule. The final regulations indicate that the rule permitting distribution without offering a rollover option for amounts of \$200 or less will be applied using the separate account rules so that, for example, a distribution of \$150 from the pre-tax account and \$150 from the Roth account could each be distributed in a simple check, without offering direct rollover. However, the regulation also states that for purposes of the automatic rollover rules, the \$1,000 limit cannot be applied separately to each portion of the account so that, for example, a distribution consisting of \$800 attributable to pre-tax contributions and \$250 attributable to designated Roth contributions must be rolled over separately to two IRAs.

The Council recommends that Treasury revise this rule to allow separate treatment for the pre-tax and Roth amounts so that Plan Sponsors are not forced to find IRA institutions willing to take low-balance accounts. Finding IRA providers willing to accept IRA rollovers between \$1,000 and \$5,000 has proven challenging for many plan sponsors. Finding IRA providers for even smaller amounts would be even more difficult. This particular rule is a significant administrative burden which will preclude some plan sponsors from adopting designated Roth contributions.

Alternatively, Treasury should at least clarify how the separate treatment under the \$200 rule interacts with the collective treatment under the automatic rollover rules by providing one or more relevant examples. For example, a distribution totaling \$1,010 consists of \$850 attributable to pre-tax contributions and \$160 attributable to designated Roth contributions. Under the \$200 rule, the \$160 attributable to designated Roth contributions can be distributed in a check without offering a direct rollover. When that amount is distributed, only \$850 remains. The Council believes that the \$850 amount should be distributable as well (after offering direct rollover) and not subject to automatic rollover because only \$850 would remain after the \$160 distribution. The Council requests that Treasury clarify the treatment of both amounts.

Loans. The separate account treatment raises questions in other areas as well such as administrative requirements for participant loans. Regulations clearly

indicate that the amortization requirements for loans apply separately to the Roth portion. Presumably, loan repayments could not be first apportioned to repay monies to the pre-tax portion of the plan followed by repayment of designated Roth contributions. However, it is not clear how far this “separate” treatment should be taken with respect to administrative requirements. Issues include whether loans need separate loan agreements, promissory notes, Truth-in-Lending notices, checks, and amortization schedules. Treasury should provide clarification on payment allocations when the loan is repaid – as contributions only, or repayment of the Roth portion in the same percentage as was borrowed from Roth contributions and earnings.

Question and answer No. 9 of the regulations appears to indicate that the 50 percent limitation on employee loans is calculated by combining the Roth account with other accounts. However, the wording of the answer should be clarified to indicate whether this combined treatment applies if the loan proceeds are not taken from the Roth account. Immediately after answering “yes” to the question, the lead-in phrase of the next sentence states “If any amount from a designated Roth account is included in a loan to an employee...” but concludes with “regardless of whether the loan is from the designated Roth account or other accounts under the plan.”

Enhanced Benefits in Annuity Contracts. Final regulations should address how the separate accounting requirement applies to annuity contracts that fund Roth 401(k) or 403(b) plans and that include both pre-tax and Roth contributions. In this regard, it is not uncommon for annuity contracts to provide enhanced benefits, such as guaranteed minimum income benefits and return of premium (ROP) death benefits. These benefits typically provide payments to participants in excess of the account value under the contract. To illustrate, consider an ROP death benefit that pays only if the account value on the date of death is less than the sum of all premiums paid under the contract. If a participant paid \$100 in Roth premiums, \$200 in pre-tax premiums, and the account value after poor investment performance was \$270 (\$90 of Roth; \$180 of pre-tax premiums), the participant’s beneficiary would be entitled to a payment of \$30 (i.e., the premiums in excess of the account value). The question arises as to the tax character of this payment. The Council believes that it should be permissible to determine the tax character using any reasonable accounting method. In the illustration above, this would mean that the tax character of the premium could be based on the relative account balances so that \$10 ($\$90/\270) would be considered a Roth distribution and the remaining \$20 ($\$180/\270) would be considered a traditional pre-tax distribution. Similarly, it should be permissible to base the tax character on the relative premiums paid (after adjustment for withdrawals), which would yield the same answer on the facts above (although the answers could be different for other fact patterns).

In addition to clarifying enhanced benefits, the Council requests clarification of treatment of basis in general for annuities purchased by qualified plans to satisfy certain distribution options. Examples could illustrate whether there are differences in what is treated as an investment in the contract depending on whether the participant has satisfied the requirements for a qualified distribution at the time of the annuity purchase. If the participant has not met the qualified distribution requirements at the time the annuity is purchased but later does meet the requirements during the payout period, Treasury could clarify how subsequent payments would be taxed.

Miscellaneous. Other separate account issues need to be addressed such as whether aggregation is required or allowed for purposes of coverage and participation testing as well as whether separate checks are required for distributions (including loans as discussed above). Final regulation section 1.401(k)-1(f)(1)(i) requires that designated Roth contributions can only be made under a plan that allows pre-tax elective contributions. The question is whether Roth contributions must be made available to all participants and whether Roth and pre-tax 401(k) contributions are aggregated or disaggregated for coverage testing under Code Section 410(b) or other discrimination testing such as testing under Code Section 401(a)(4). Regulation section 1.401(a)(4)-4(e)(e)(iii)(D) only requires the right to make the same rate of elective contribution under 1.401(k)-6, and 1.401(a)(4)-4(e)(3)(iii)(D) only requires the right to make the same rate of after-tax employee contributions as described in 1.401(m)-1(a)(3) (which does not apply to Roth). If coverage requirements are separate, the regulations should clearly indicate that coverage percentages will not include residents of Puerto Rico who cannot elect designated Roth contributions under Puerto Rican law.

Five-Taxable-Year Period

Tracking. In general, a distribution from a designated Roth contribution can only be a qualified distribution if it is made after a five-taxable-year period beginning with the first taxable year in which the first Roth contribution to the participant's account was made. The proposed regulations indicate the period is not redetermined if a participant receives distribution of his Roth account during the five-taxable-year period and subsequently makes additional Roth contributions. The Council recommends that Treasury clarify the application of this rule through various examples which would indicate whether this is an absolute rule that applies regardless of when the participant depletes the account and subsequently makes contributions. For example, is the five-taxable-year period based upon the earlier contribution if the participant terminates employment, receives a full distribution of the Roth account, and is subsequently rehired (regardless of the length of the separation from employment)? What if the account is zeroed out because of excess deferrals, excess contributions or excess annual additions?

Beginning of Period. Treasury should also provide guidance on determining the beginning of the five-taxable-year period in unusual circumstances such as permitted retroactive contributions under the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) – the year of actual contribution or the year to which the contribution is attributed? The proposed regulations indicate that an indirect rollover (participant takes a distribution and does a 60-day rollover of the taxable portion) resets the five-taxable-year clock. Treasury should clarify whether the clock resets for a participant who already has a Roth account in the recipient plan or simply uses the date from the recipient plan. If the clock resets for the rollover, is the recipient plan required to track two different five-year clocks or is the participant penalized by applying a new five-year clock to earlier Roth contributions? In addition, although there is a special rule in the proposed regulations (Question and answer No. 4(b)) allowing the participant to use an earlier start date in the event of a direct rollover to a qualified plan, there is no clear rule for determining the start date for an account that contains only an indirect (60-day) rollover money. Does the five-taxable-year period begin on the date the indirect rollover is received by the plan? Again, examples would be helpful.

Minimum Distributions. The Council recommends that Treasury clarify whether a distribution is qualified based on the year to which the distribution is deemed to relate or to the actual year of distribution. For example, a participant makes designated Roth contributions in 2006 to 2008 at ages 65 to 67, then retires in 2009, and attains age 70-1/2 in 2010. If the “2010” distribution is made on April 1, 2011, is the participant considered to have met the five-year rule at the time of the distribution?

Rollovers

Rollover to Employer Plan. The proposed regulations indicate non-taxable portions of a distribution from a designated Roth account can only be rolled over to another employer plan through a direct rollover (indirect rollovers are permitted to IRAs). One question in the proposed regulations appears to require the participant to roll over the entire distribution in order to roll over non-taxable portions. This requirement would prevent a partial rollover of any qualified distribution and some partial rollovers of nonqualified distributions. Since this “entire distribution” language is only contained in one portion of the regulations and is not supported by language in other portions, the Council requests that Treasury clearly indicate whether or not Treasury intended to require a rollover only of the entire distribution in this situation. The Council respectfully requests that Treasury clarify that rollover of the entire distribution is not necessary because this all-or-nothing approach could prompt more retirement accumulation leakage from the system (participant needs to keep a portion of the

nontaxable distribution for other purposes but would like to roll over the rest). If Treasury simply intended to indicate that rollovers that include nontaxable amounts must be directly rolled over, Treasury should clarify that rollover of the entire distribution is not required.

If rollover of the entire distribution is required, it would be helpful for Treasury to indicate whether the separate accounting rules apply so that the entire distribution for this purpose does or does not include the pre-tax account or amounts not subject to rollover such as required minimum distributions. If the “entire distribution” is not required, it would be helpful for Treasury to clarify, through examples, the tax, basis and earnings treatment of multiple direct rollover distributions. For example, a participant with a \$10,000 Roth account that consists of \$7,000 basis and \$3,000 earnings splits the direct rollover between two plans with each receiving \$5,000. Does each plan receive \$3,500 basis and \$1,500 earnings or does it depend upon when the two rollovers are processed or executed?

The proposed regulations do not appear to clearly indicate whether a recipient plan must separately account for rollovers that, except for the rollover, would be entirely taxable. Question and answer No. 5 does not contain language requiring separate accounting for rollovers consisting entirely of taxable amounts and preamble language relating to rollover of designated Roth contributions only states the separate accounting requirement in connection with rollover of amounts not includible in income. The Council requests that Treasury clarify whether the recipient plan must separately account for rollovers that would be entirely taxable.

The regulations clearly indicate that Roth contributions and Roth rollovers are treated as a single separate account for purposes of applying Code Section 72. In order to simplify administration, the Council respectfully requests that Treasury reconsider this portion of the rule and allow plans to treat Roth contributions and Roth rollover amounts as separate contracts.

Another issue that could be easily clarified by Treasury is whether the recipient plan must allow pre-tax deferrals (i.e., are rollovers to profit-sharing or money purchase pension plans permitted). The proposed rule indicates that a plan that offers designated Roth contributions must also permit pre-tax deferrals but does not indicate whether this is a requirement for rollovers. Although it is unlikely that plans without pre-tax deferrals would permit Roth rollovers, clarification would be helpful.

Rollover to IRA. Language in the preamble of the regulation conflicts with guidance in the actual regulation and the Council recommends that Treasury formally resolve this issue. The proposed regulations indicate that partial

rollovers to IRAs are treated as consisting first of taxable earnings and include a relevant example. The preamble to the regulations states the opposite. Treasury representatives have informally indicated that language in the preamble was the result of a typographical error and the treatment described in the regulation itself is appropriate. The Council requests that Treasury formally clarify that partial rollovers to IRAs are treated as consisting first of taxable earnings.

Rollovers between Roth 401(k) and Roth 403(b). The proposed regulations appear to allow only taxable amounts to be rolled over between 401(k) and 403(b) plans. This would preclude the rollover of any qualified distribution and the rollover of the non-taxable portion of any nonqualified distribution. The latter result would also cause significant administrative issues for plans that do not plan to provide for separate elections for the taxable portion of a Roth distribution. This proposed rule is contrary to the policy established in Code Section 402(c)(2) which generally permits rollover of non-taxable amounts. This section, which was added by Congress in the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), was intended to promote portability among plans according to the legislative history. The Council recommends placing Roth rollovers on equal footing with other types of rollovers by allowing direct trustee-to-trustee transfers of non-taxable Roth amounts.

Reporting

Distributing Plan. The proposed regulations require the distributing plan to report to the recipient plan the amount of contributions or basis in the Roth account as well as the first year of the five-taxable year period (or that the distribution is a qualified distribution). The Council believes the total amount of the distribution should be reported as well. An example helps illustrate the need for this reporting. A participant takes a \$10,000 nonqualified distribution which consists of \$7,000 basis and \$3,000 earnings but elects a direct rollover of \$3,000 of the \$10,000 to another 401(k) plan. Under the regulations, the recipient plan should treat the rollover first as earnings but will only receive a report that the basis was \$7,000 and the first year of the five-year-period. Since the recipient plan does not receive information on the total amount of the distribution, it cannot determine what percentage of the \$3,000 should be considered earnings.

The Council also recommends that Treasury clarify whether the report must be provided to both the recipient plan administrator and the receiving financial institution and what actions are required if a post-distribution correction changes the reporting. The Council further recommends that Treasury provide guidance to recipient plans that do not receive a report from the distributing plan (default treatment) and a model form for the report. Issues could arise if the report is late and the employee requests a distribution. Perhaps plans could refuse to accept Roth rollovers that are not accompanied by the required data which could be

included on a check stub or a distribution statement that documents the source of the rollover. Finally, Treasury could provide clarification regarding which party is the “responsible party” for purposes of providing the report and whether there are penalties for failing to report. If multiple parties are involved (such as when a plan changes recordkeepers in connection with a corporate transaction immediately after a rollover occurs), it may not be clear who has primary responsibility for reporting.

Recipient Plan. The proposed regulations require that a plan receiving an indirect rollover of the taxable portion of a Roth distribution file a report with Treasury (by the due date for filing 1099-R) and spells out some of the required contents of the report. This is a new reporting requirement which does not exist for any other indirect rollover and may discourage plan sponsors from accepting indirect rollovers. The Council recommends eliminating this requirement since the indirect rollover would be reported on the employee’s tax return. Alternatively, the Council recommends that Treasury publish a model form for this reporting requirement.

Revised Forms. Service providers that provide administrative services to plans routinely use automated computer systems that key the reporting requirement at the time of a distribution request. Any change in reporting requirements after potential distributions requires extensive manual processes to “correct” the reporting that the system has been programmed to provide. Designated Roth contributions have been permitted in some plans since January 1, 2006, and it is very important that 1099-R reporting requirements for Roth distributions and revised 1099-R forms be published as soon as possible (or that Treasury permit alternative methods of compliance). Although the proposed rule indicates a separate 1099-R will be issued for Roth distributions, issues remain such as whether the separate 1099-R can include all after-tax contributions when the distribution is paid to the participant. In addition, the Council recommends that Treasury consider revising the existing 1099-R form by adding a separate box or code for the Roth distribution, rather than requiring a separate 1099-R for Roth distributions.

Revised Notice. The Council requests that Treasury revise and update the distribution notice model previously provided under Code Section 402(f) to reflect designated Roth distributions and other statutory and regulatory changes made since the last revision of the model notice. Distributions that include designated Roth contributions will be very confusing to participants and Treasury could help alleviate this confusion by providing a standard explanatory notice.

Employer Stock

NUA. The proposed regulations provide rules relating to the distribution of employer securities and the application of the net unrealized appreciation (NUA) election of Code Section 402(e)(4). For a distribution of employer stock attributable to pre-tax contributions (or a non-qualified designated Roth distribution), the employee can elect to be taxed only on the portion of the distribution treated as basis (basically the amount the plan paid for the stock), and defer taxation of the gains or NUA until the employee subsequently sells the stock (with separate account treatment for the designated Roth distribution). For a qualified distribution of employer stock attributable to designated Roth contributions, the distribution is not taxable and the basis in the employer stock is the fair market value on the date of the distribution.

Although the rule appears straight-forward, it is likely that questions will arise in application that could be clarified through published examples. Under a simple (although extreme) example, the participant contributes \$4,000 in designated Roth contributions and invests half in employer stock and half in another investment. The other investment drops to \$1 while the employer stock increases in value to \$4,000. The “cost” basis in the employer stock is \$2,000 but the participant’s Roth basis is \$4,000. In a nonqualified distribution, does the participant receive a pro-rata step up in basis on the employer stock for the Roth exclusion? Calculation examples would be helpful.

Dividends. The proposed regulations provide that 404(k) dividends on company stock that are paid directly to participants can never be paid as part of a qualified distribution, even if the dividends are paid from a Roth account and paid at a time that would otherwise give rise to a qualified distribution. In contrast, 404(k) dividends that are reinvested and subsequently distributed may be paid as part of a qualified distribution. The Council respectfully urges the Treasury to reconsider this conclusion. As a threshold matter, the Council is not aware of any basis for this conclusion in either the statute or legislative history. Moreover, this distinction would appear to be completely arbitrary as a matter of substance. Except for death or disability, qualified distributions will be made after a participant attains age 59½, which is the age at which many plans provide that amounts may be freely withdrawn. Under the proposed regulations, a participant that elects to have a dividend distribution that is attributable to Roth amounts paid directly to them in cash would be taxed on a portion of the dividend (to the extent of earnings). However, a participant that elects to reinvest the same dividend and then take a distribution would be entitled to the exclusion for qualified distributions (assuming it otherwise qualified) This is the case apparently even if the distribution is made on the same day as it would otherwise be paid directly to the participant. The only difference being that in the later case, the dividend was formally reinvested and then distributed. This type of form over substance approach makes very little sense, will be enormously confusing to participants, and should be reconsidered. Dividends

that are paid on company stock should be excludible from income to the same extent that other distributions are excludible from income.

Miscellaneous Issues

Hardship Distributions. Treasury guidance has indicated that plans must separately determine the amount of elective deferrals available for hardship and the amount of designated Roth contributions for tax purposes because the limit on hardship distributions does not include earnings on employee contributions but a distribution from a Roth account must include a pro-rata portion of the earnings for tax purposes. This will cause an administrative nightmare unless modifications are made in the proposed treatment. Although it is not entirely clear from the guidance, plans may need to separately track (1) pre-tax deferrals eligible for hardship, (2) designated Roth contributions eligible for hardship, (3) pre-tax deferrals actually distributed, (4) designated Roth contributions actually distributed, and (5) earnings attributable to designated Roth contributions actually distributed. Some plan administrators believe it is necessary to track pre-tax contributions available for hardship separately from Roth 401(k) contributions available for hardship and then debit each type of contribution separately at the time of the request because of the separate accounting treatment. Others believe that the tracking of the amount available for hardship is done across both types of contributions. This portion of the guidance has probably led to the most confusion (and disagreement) among plan administrators and recordkeepers and significant clarification is needed.

The Council strongly urges Treasury to match up calculation of the limit with the amounts actually distributed by prohibiting distribution of earnings for a hardship. Any different treatment would be very confusing for plan participants. The Council understands that Treasury is concerned this method would result in tax-free hardship distributions. However, this tax treatment would be no different from the tax treatment the participant would have if the distribution (not exceeding basis) is taken from a Roth IRA. It does not seem appropriate to require plans to perform calculation gymnastics to ensure tax treatment that would be different than that afforded the Roth IRA. Nevertheless, Treasury could address this perceived problem, in part, by instituting a hierarchy of the source of a hardship distribution which would place the designated Roth contributions last.

If Treasury rejects this treatment and continues to require separate tracking, the administrative burden could be eased somewhat by allowing plans to subtract only the distributed Roth basis from the amount eligible for hardship distribution (instead of both basis and earnings). Alternatively, Treasury could allow plans to voluntarily elect to exclude designated Roth contributions and

earnings from the hardship distribution but still permit Roth deferrals to be included for purposes of determining the hardship distribution limit.

Loans. The proposed regulations indicate that a loan default cannot be a qualified distribution even if the default (and associated imputed income event) occurs at a time when the distribution would otherwise be considered qualified. The Council respectfully suggests that Treasury reconsider this aspect of the proposed regulation. A loan default is a distribution for federal income tax purposes and should be treated just like any other distribution, including for purposes of section 402A. As a result, a loan default should be non-taxable to the extent the distribution is otherwise qualified. The approach taken in the proposed regulations with respect to deemed distributions due to a loan default will create a trap for unwary plan participants, disadvantages participants generally, and adds yet another layer of complexity to an already difficult set of regulations.

EGTRRA Sunset. Many plan sponsors are hesitant to implement designated Roth contributions for their plans because the proposed rule fails to address the scheduled sunset of the law in 2010. Although plan sponsors hope that Congress will make the provisions of EGTRRA permanent before 2010, current law includes the sunset and the regulations provide no assurances of tax treatment, eligibility for rollover, etc., in the event that current law is not extended. Although the Council recognizes that Treasury probably does not want to expend considerable time and effort to address an issue that may become moot, it is an issue plan sponsors must wrestle with in deciding whether to implement designated Roth contributions. These concerns could be addressed, in part, by a simple statement in the regulations that Treasury expects previous Roth contributions to be “grandfathered” in the event of the sunset of EGTRRA, and that grandfather treatment would include taxation of distributions and the ability to roll over the pre-2011 designated Roth contributions.

Anti-Abuse Provision. Question and answer No. 13 contains a basic anti-abuse provision that prohibits transactions or accounting methodology that has the effect of directly or indirectly transferring value from another account into the Roth account. The Council requests additional clarification on the application of this provision to investment elections and allocation of fees. For example, are participants permitted to choose different investment allocation elections for designated Roth accounts so that designated Roth accounts are invested in higher risk, higher yield investment options than other accounts? In addition, are any reasonable allocations of fees permitted or do accounting systems need to be redesigned to insure that they never benefit designated Roth accounts to the detriment of other accounts? For example, allocation of redemption fees could be problematic if the participant is only currently contributing Roth amounts and, therefore, any current “buys” are made with Roth contributions. A sale is

recorded against all accounts, resulting in a redemption fee assessed against all accounts. The fee would not have been assessed “but for” the Roth purchase but it is allocated against all accounts because sales generally occur across accounts. The Council requests clarification of this provision.

Catch-up Contributions. The Council requests that Treasury clarify that participants may make catch-up contributions on either a pre-tax or Roth basis.

QDROs. The proposed rule indicates that the participant’s five-taxable-year period is to be used to determine if a payment to an alternate payee could be a qualified distribution. Treasury should also clarify whether it is the participant’s or alternate payee’s age, death or disability that is used to determine whether the distribution is qualified.

Safe Harbor. The Council recommends that Treasury provide guidance on any notice or other requirements that would apply to safe harbor 401(k) plans that add designated Roth contributions in the middle of the year.

Brokerage Accounts. Finally, the Council understands that separate accounting rules could have significant effects on plans that have brokerage accounts or windows, especially those plans that provide daily valuations. Council members are researching best practices to address potential concerns and the Council intends to provide additional informal comments to Treasury in this area at a later time.

Again, we appreciate the opportunity to comment on the proposed Roth 401(k)/403(b) rules. We believe that the American Benefits Council brings an important and unique perspective by the employer sponsors of retirement plans and we would be pleased to make this information and perspective available to Treasury. If additional information from us would be helpful, please call me at 202-289-6700.

Sincerely,

A handwritten signature in black ink, appearing to read "Jan Jacobson", written in a cursive style.

Jan M. Jacobson
Director, Retirement Policy