



June 1, 2010

Via Electronic Delivery

George H. Bostick
U.S. Department of the Treasury
Benefits Tax Counsel

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

Dear Mr. Bostick:

Thank you for taking the time to meet with the American Benefits Council (Council) and other interested stakeholders to discuss the tax treatment of a partial rollover to an IRA from a plan that includes amounts attributable to after-tax employee contributions. We greatly appreciate the attention that you and the other Treasury and Internal Revenue Service (Service) representatives devoted to the issue. We are writing today to follow up on our discussion and emphasize the need for guidance with a prospective effective date that addresses the issue.

There is no published guidance with precedential value addressing the extent to which section 402(c)(2)¹ treats a partial rollover as consisting of pre-tax earnings rather than a pro rata share of after-tax basis and pre-tax earnings. However, in a newsletter published by the Service in March, 2010² and in the updated 402(f) notice published in September, 2009,³ the Service suggests that the “pre-tax first” rule of section 402(c)(2) only applies to a 60-day rollover. The rationale underlying this analysis is apparently that the pro rata rule of section 72 applies first to any distribution; section 402(c)(2) merely provides an ordering rule that applies if a portion of a single distribution is subsequently rolled over. In the view expressed in the newsletter and 402(f) notice, the only circumstance this is

¹ All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

² *Employee Plans News*, Volume 10, Spring 2010, available at <http://www.irs.gov/pub/irs-tege/spr10.pdf>.

³ Notice 2009-68.

possible is where a participant receives a single sum distribution and then rolls a portion to an IRA as a 60-day rollover.

Under this view, if two payments are made for the benefit of a participant, even if made as part of a single distribution request, such as a split rollover to a traditional IRA and a Roth IRA or a cash payment and a rollover to a traditional IRA, there are two distributions, each comprised of a pro rata share of pre-tax earnings and after-tax basis.⁴ As we discussed, this analysis is contrary to widespread tax reporting and withholding practices. We are not aware of a single plan or payor who has applied section 402(c)(2) in this manner. To the best of our knowledge, the prevailing practice has been to treat two payments made in connection with a single distribution request as a single distribution to which section 402(c)(2) applies.

The Council strongly believes that the prevailing practice properly applies section 402(c)(2). First, we believe that the prevailing approach represents better tax and retirement policy. There is no question that taxpayers may avail themselves of the “pre-tax first” rule of section 402(c)(2) through a 60-day rollover. It is only the taxpayer who does not have the resources to make up for the mandatory withholding on the taxable portion of the distribution or is not well-advised who in the Service’s informal view will not benefit from section 402(c)(2). This notion that an indirect rollover has more favorable tax treatment than a direct rollover is clearly at odds with retirement policy’s preference for direct rollovers. Such an approach also places affluent taxpayers at an advantage relative to less affluent taxpayers because these individuals will be better situated to make up for the mandatory withholding. It is also clear that tax policy should not favor a particular form of transaction over another form, at least in situations where the transactions are economically and substantively equivalent. Such a preference for a particular form creates a trap for the unwary and places an inappropriate premium on tax planning and advice. Put simply, the position reflected in the 402(f) notice and the newsletter is the type of rule that undermines confidence in the retirement system.⁵

⁴ Treasury regulation 1.402A-1, Q&A-5(a) discusses the application of section 402(c)(2) in the context of nonqualified distributions from a designated Roth account. It might be read to suggest this interpretation of the interaction of sections 72 and 402(c)(2). However, the regulation is fundamentally addressing the prohibition against 60-day rollovers of after-tax basis into plans, not section 402(c)(2) and, in any event, the regulation is inapplicable to traditional after-tax amounts. Finally, the language is opaque even for nonqualified distributions from designated Roth accounts.

⁵ One might fairly question from a tax policy perspective whether a taxpayer should be able to separate after-tax basis from pre-tax earnings. We think there are strong arguments for such flexibility, particularly the ability to effect rollovers, but that is not the relevant tax policy. Congress has made the decision to permit the separation of after-tax and pre-tax amounts. The

Second, it is apparent that the position reflected in the newsletter and the 402(f) notice is, at best, incomplete. Section 402(c)(2) applies equally to rollovers to plans as well as IRAs. Many plans, however, do not accept rollovers of amounts that include after-tax basis because these plans are not set up to track basis and report distributions attributable to an after-tax source. Under the prevailing view, if a plan does not accept rollovers of after-tax contributions, a participant may nonetheless roll over an amount from an after-tax source. The amount that may be rolled over is equal to the pre-tax earnings. The employee can either receive cash equal to the after-tax basis or roll an amount equal to the after-tax basis to an IRA. However, as expressed in the newsletter and the 402(f) notice, both payments would be treated as including a pro rata share of basis and earnings under section 72 and the pre-tax first rule of section 402(c)(2) would never come into play. That is, each payment would be treated as a separate distribution to which the pro rata rule applies. The net result is that the participant could not roll over to the plan at all. This is obviously not the right answer. It defeats the underlying purpose of section 402(c)(2) to facilitate rollovers where a distribution includes after-tax amounts and is at odds with efforts to discourage leakage from the retirement system.

During our meeting, a government representative suggested that a participant may roll over the pre-tax portion of a distribution from an after-tax source to a plan that does not accept rollovers of after-tax basis. The notion was apparently that the after-tax amount would “bounce off” the plan by operation of law and, in such a limited circumstance, after-tax and pre-tax amounts could be divided, even though two payments are made. We appreciate this effort at rationalizing the informal position reflected in the 402(f) notice and the newsletter, but we fail to see a statutory or other ground for such a rule. There are also at least two serious policy flaws with such a rule. It would apparently force a participant who wants to roll to the plan to receive the after-tax basis in cash. The participant could not directly roll over the after-tax basis, effectively encouraging leakage from the system and imposing a penalty for a direct rollover to the plan. Such a rule would also fundamentally change the relationship between a plan that pays a rollover and a plan that accepts a rollover. Under current law, there is very little coordination required between plans with respect to rollovers. The paying plan typically provides information reflecting that it is a qualified plan, a statement of any basis in the payment, and any information necessary for a rollover that includes Roth amounts. The receiving plan generally relies on the representations of the paying plan.⁶ The notion suggested at the meeting, however, would require the payor plan to know whether the receiving plan

relevant policy is about consistency among economically and substantively equivalent transactions, not the appropriateness of splitting after-tax basis from pre-tax earnings.

⁶ See Treas. Reg. § 1.401(a)(31)-1, Q&A-14 (receiving plan must “reasonably conclude” that the rollover is a valid rollover).

accepts after-tax rollovers. It would require in effect a two-way dialogue between the plans, which would be a radical change in the rules governing inter-plan rollovers and a change that would discourage portability.

Third, the Service's informal position is not consistent with the evolution of the rollover rules, which perhaps explains why the Service's position is at odds with prevailing practice. When rollovers were added to the Internal Revenue Code in 1986, the Service published precedential guidance concluding that any amount rolled over was treated as pre-tax first.⁷ This guidance was published at a time when the only form of rollover was a 60-day rollover. The IRS never issued guidance updating this rule after direct rollovers were added to the Code, but many plans and practitioners reasoned that the same pre-tax first rule applied in this context. The direct rollover was simply an alternative to the 60-day rollover and was not meant to change any other rule. Moreover, as discussed above, any other answer would effectively preclude direct rollovers since after-tax amounts could not at that time be rolled over and the purpose of the direct rollover rules was to encourage amounts to stay in retirement solution.

Given the law at the time the Code was amended as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) to allow rollovers of after-tax amounts to IRAs and to plans, it was natural to question whether the pre-tax first rule continued to be applicable. After all, its purpose had largely evaporated. However, as part of a technical correction to EGTRRA in the Job Creation and Worker Assistance Act of 2002 (JCWAA), Congress added the flush language in section 402(c)(2), which is the current pre-tax first rule. The flush language closely tracks, and is obviously cribbed from, the language in the IRS guidance creating the pre-tax first rule, and many interpreted the change to clarify that this rule continued to be applicable, notwithstanding that after-tax basis could now be rolled over. This made sense because these rules apply equally to rollovers to plans, and plans are free to, and frequently do, not accept rollovers of after-tax amounts. Thus, it is logical to understand the flush language in section 402(c)(2) as preserving pre-EGTRRA law, which broadly applied a pre-tax first rule. The position reflected in the newsletter and 402(f) notice, however, turns this history on its head, by suggesting that the technical correction adding the flush language to section 402(c)(2) was a major substantive change to narrow the pre-tax first rule solely to 60-day rollovers.

Finally, we see little in the text of the statute or other applicable authority that compels the conclusion that the pre-tax first rule is limited to 60-day rollovers. We appreciate that one can read section 402(c)(2) to apply only to a single distribution but, as we have discussed, it is very reasonable to treat a unitary distribution request as a single distribution, even if payments are split among

⁷ Notice 87-13, Q&A-18.

two payees, such as a traditional IRA and a Roth IRA or the participant and the participant's traditional IRA.⁸ The Council's members have made clear that they have little trouble identifying when two payments are part of a single distribution, simply because it will be apparent from the transaction, typically because the participant submits a single set of paperwork or makes a single request for a complete distribution of their account balance. Moreover, we are not aware as a practical matter of situations in which two payments made as part of a single distribution request are made at materially different times, and we would be amenable to a rule that limits single distribution treatment to payments that are made within a reasonably contemporaneous time period.

For these reasons, the Council continues to believe that section 402(c)(2) allows a participant electing a partial rollover to effectively split the basis and the earnings component of a distribution, whether the two components are received partly in cash and partly in a rollover or paid in two rollovers to a traditional and Roth IRA. This is the right answer from a policy, fairness and technical perspective.

Prospective Guidance

While we feel strongly about the right substantive answer, we also wish to emphasize the need for an appropriate transition. We are concerned that any new guidance has the potential to disturb the tax treatment of potentially tens of thousands of taxpayers whose individual income taxes could be affected. These taxpayers have been issued information returns reporting tax basis, and have had income tax withholding applied, in light of the payors' reasonable interpretation of the statute. The disruption associated with trying to "unscramble the egg" would be profound, given the possibility of both amended Forms 1099-R and amended individual income tax returns as well as concerns about income tax withholding. For these reasons, we strongly recommend that any guidance explicitly state that the Service will not challenge a taxpayer's reasonable determination of basis in connection with a partial rollover that was completed prior to the effective date of any final guidance.⁹

⁸ There are other contexts where the applicable rules treat two payments made as part of a single distribution request as a single distribution. See Treas. Reg. § 1.401(a)(31)-1, Q&A-9 (treating a partial rollover with a cash payment as a single distribution). We appreciate that other contexts treat two payments as two distributions, but nonetheless it is clear that the prevailing approach to section 402(c)(2) is not fundamentally at odds with the fabric of the retirement system.

⁹ As we discussed, there are plans that treat a direct rollover of a portion of an after-tax account as consisting of pre-tax amounts first, even if the rollover is the only amount paid. The rationale for such an interpretation is that any other rule penalizes a participant who wants to roll over to a plan by forcing the participant to take a cash distribution equal to the after-tax basis if the receiving plan does not accept after-tax amounts. The participant cannot leave the after-tax basis in the paying plan. This interpretation was not irrational in light of the public policy of keeping

It is also critical that plan administrators and payors have sufficient lead time to make systems changes, if any are required to comply with the new rules. We understand that very few plan administrators and payors have made changes to their systems in light of the 402(f) notice and the recent newsletter. Interested parties have not changed in response to the informal guidance largely because it is not precedential guidance, the logic underlying the informal Service position is questionable, and there has simply not been sufficient time to make the necessary changes. Moreover, during our meeting, we discussed a number of different fact patterns and, depending on the form of the transaction, different possible tax treatments. The suggestion was that the ultimate tax treatment could be fairly complicated, and we are anxious to ensure an orderly transition to any set of new rules. As you know, programming changes involve substantial resources and require careful planning. The particular changes at issue would involve the tax logic of recordkeeping systems, which is generally considered the most complicated and deepest logic in the systems. For this reason, our members have indicated that it will take at least 12 to 18 months to implement any material changes.

Further, we are sensitive to the need for corollary transition relief. Many plans provide the full section 402(f) notice to participants and then provide the summary notice at the time of a distribution request. It is likely that some plans will need time to issue new 402(f) notices, which reflect the new guidance, and it is important that any transition encompass the need to develop and provide revised participant communications in a cost efficient manner (allowing for distribution on a regular schedule).

Also, if the Service's informal position is ultimately adopted, it is possible that many plans will have inadvertently accepted after-tax contributions, notwithstanding that the terms of the plans provide only for rollovers of pre-tax amounts. Thus, it is essential that any transition provide relief from disqualification for plans accepting rollovers.

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Again, thank you for all your attention to these issues. We recognize that Treasury and the Service have a very busy docket, and we appreciate your hard

retirement assets in plan solution, the lack of guidance on the interaction between Notice 87-13 and the direct rollover rules before EGTRRA, and the reasonable conclusion that the addition of the flush language in section 402(c)(2) was confirmation that pre-EGTRRA rules continued to apply. Hence, even if the guidance ultimately conforms to our view, we recommend a prospective effective date and transition relief.

work. If you have any questions about these comments, please contact Jan Jacobson, the Council's senior counsel, retirement policy, at 202-289-6700.

Sincerely,

A handwritten signature in black ink, appearing to read "Jan Jacobson". The signature is fluid and cursive, with the first name "Jan" and last name "Jacobson" clearly distinguishable.

Jan Jacobson

cc: J. Mark Iwry
Alan Tawshunsky
Andrew Zuckerman