

COMMENT LETTER

April 26, 2006

ICI Comments Roth Account Distributions (pdf)

April 26, 2006 VIA ELECTRONIC MAIL Internal Revenue Service CC:PA:LPD:PR (REG-146459-05) 1111 Constitution Avenue, N.W. Washington, D.C. Re: Proposed Regulations Concerning Designated Roth Accounts Ladies and Gentlemen: The Investment Company Institute,¹ on behalf of its investment company members, submits these comments concerning the proposed regulations governing designated Roth accounts under section 402A of the Internal Revenue Code.² Because Roth contributions are permitted beginning January 1, 2006, it is critical to the operation of 401(k) plans and 403(b) arrangements offering a Roth feature to have clear and comprehensive guidance on distributions from these accounts. Plans and their recordkeepers also must be given sufficient time to establish systems and procedures to accommodate distributions from designated Roth accounts. We urge the Internal Revenue Service to make certain clarifications or changes to the proposed regulations, and issue additional guidance as appropriate, on an expedited schedule. In this letter, we ask the Service to simplify the proposed rules, such as those for reporting and hardship distributions, so that plans and service providers offering Roth contributions can operate efficiently and without unnecessary cost. Some of the recommendations also would lessen the potential for confusion among plan participants. The Institute also suggests a number of clarifications to the proposed rules on rollovers of designated Roth accounts and certain issues relating to 403(b) arrangements, where the proposed guidance is unclear. In addition to providing comments on the 1 ICI members include 8,606 open-end investment companies (mutual funds), 653 closed-end investment companies, 160 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$9.207 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 89.5 million shareholders in more than 52.6 million households. ² The provisions appear in amendments to the regulations under Code sections 402(g), 403(b), and 408A, and in new regulations under Code section 402A. Internal Revenue Service April 26, 2006 Page 2 of 9 proposed regulations, we urge the Service to issue guidance updating Form 1099-R and issue a revised model notice under Code section 402(f). The mutual fund industry's interest in the proposed regulations is substantial, because Institute members offer mutual fund shares as investment options under 401(k) plans and 403(b) arrangements. According to Institute estimates, \$1.09 trillion of 401(k) assets and \$294 billion of 403(b) assets were invested in mutual funds as of December 31, 2004.³ Mutual fund companies also provide a broad range of services to 401(k) and other defined contribution plans, in addition to providing investment options for these plans. Many fund companies, for example, provide plan recordkeeping, tax compliance and reporting, and participant education services. Rollovers from Designated Roth Accounts The

proposed regulations provide that the nontaxable portion of a designated Roth account distribution from a plan qualified under Code section 401(a) may be rolled over into another designated Roth account in a plan qualified under Code section 401(a), but only through a direct rollover.⁴ There is a similar rule for rollovers between 403(b) arrangements. A distribution of a designated Roth account made to an employee would be eligible for rollover into a Roth IRA within 60 days. An individual would be able to make an indirect rollover of the otherwise taxable portion of a distribution from a designated Roth account into another designated Roth account within 60 days, but the period of participation would not be carried over to the recipient plan for purposes of the five-year holding period.⁵ We have several comments on these provisions.

Rollovers Between 401(k) and 403(b) Plans The Institute encourages the Service to reconsider its position on rollovers of non-taxable amounts between 401(k) and 403(b) plans. In the interest of portability, we believe that participants should be permitted to roll over non-taxable amounts between 401(k) and 403(b) plans. Allowing direct rollovers between 401(k) and 403(b) plans would be consistent with the portability rules for other elective deferrals under Code section 402(g). The preamble to the proposed regulations implies that an indirect rollover of taxable earnings could be made from a 401(k) plan to a 403(b) plan, or vice versa. This contrasts with the provisions of the proposed rule that would prohibit a direct rollover between a 401(k) plan and a 403(b) plan. The 3 2005 Investment Company Fact Book (45th ed.) at 40.

⁴ See Proposed Regulation § 1.402A-1, Q&A-5. ⁵ See Proposed Regulation § 1.402A-1, Q&A-5(c). Internal Revenue Service April 26, 2006 Page 3 of 9

Institute requests clarification that indirect rollovers of taxable earnings in Roth accounts could be made between 401(k) and 403(b) plans.

Acceptance of Designated Roth Account Rollovers The Institute requests clarification that a plan is not required to accept direct or indirect rollovers from designated Roth accounts, and that if a plan does accept designated Roth account rollovers, the recipient plan may establish designated Roth accounts for rollover contributions without providing for regular designated Roth contributions to the plan.

Partial Rollovers It is unclear from the proposal whether a participant may roll over part of a distribution into another designated Roth account (other than through an indirect rollover of taxable earnings). ⁶ The Institute requests clarification that a direct rollover into another designated Roth account may be a rollover of only a portion of the distribution.⁷

Section 1.402A-1, Q&A-5(b) and (d) of the proposed regulations provides that a partial rollover of a nonqualified distribution would consist first of any earnings on the designated Roth contributions. However, the preamble to the proposed regulations states that the portion not rolled over is treated as consisting first of the amount of the distribution that represents earnings. We request confirmation that the amount rolled over should be treated as consisting first of earnings on the designated Roth contributions, despite the preamble language to the contrary.

Rollovers by Alternate Payees and Beneficiaries The proposed regulations provide that an employee's five-year holding period is not redetermined for any portion of his or her designated Roth account, even if the employee dies or the account is divided pursuant to a qualified domestic relations order.⁸ In other words, the employee's holding period would carry over to the employee's designated Roth account in the hands of a

⁶ See Proposed Regulation § 1.402A-1, Q&A-5(a) and (b). ⁷ The Institute also requests clarification for situations where a participant requests a distribution or rollover from a designated Roth account and other plan accounts (e.g., pre-tax elective deferrals). This situation raises a number of issues, including whether the plan may issue only one check and whether a rollover of only the Roth portion of the distribution would be considered a rollover of the entire distribution. An example applying the "separate account" rules in this context would be helpful. Furthermore, if the "separate account" rules apply, by implication, the same analysis could be applied to automatic rollovers under Code section 401(a)(31)(B), so that the \$1,000 limit would apply separately to the designated Roth

account, as discussed later. 8 See Proposed Regulation § 1.402A-1, Q&A-4(c). Internal Revenue Service April 26, 2006 Page 4 of 9 beneficiary or an alternate payee. The Institute requests clarification as to whether the employee's holding period, if beginning earlier, would apply to the entire designated Roth account of a beneficiary or alternate payee who is a participant in the same plan (or who is a participant in another plan to which the employee's designated Roth account is rolled over). Alternatively, the employee's holding period could apply only to that portion of the beneficiary's or alternate payee's designated Roth account attributable to the employee. Reporting Rollovers and Distributions from Designated Roth Accounts Notice to Recipient Plan For a direct rollover from one designated Roth account to another, the plan administrator of the distributing plan would be required to provide to the plan administrator for the recipient plan either a statement of the year in which the five-year holding period began and the portion attributable to investment in the contract, or a statement that the distribution is a qualified distribution.⁹ The Institute requests clarification that, when a rollover contribution includes both Roth and other amounts (e.g., pre-tax elective deferrals), the distributing plan must notify the recipient plan of the total amount of the distribution attributable to the designated Roth account, so that the recipient plan can allocate that amount to a separate account. The proposed regulations would require the distributing plan to provide the aforementioned statement to the recipient plan within a reasonable period following the direct rollover, but in no event later than 30 days following the direct rollover.¹⁰ The Institute requests that the proposed rule be changed to require the statement to be included with the direct rollover check sent to the recipient plan or participant. Recipient trustees will need the information provided in the statement at the time the rollover is processed. Receipt of the statement at a later date may require the recipient plan to make adjustments to its records after the rollover contribution is received and processed. Moreover, if the recipient plan receives the statement before the participant delivers the rollover contribution,¹¹ the plan may not yet have a record of that particular participant and may have difficulty linking the statement with the subsequently received rollover contribution. Because it is common for distributing plans to provide certain information about a distribution on the check stub, we believe this change would not unduly burden distributing plans. 9 See Proposed Regulation § 1.402A-2, Q&A-2(a). 10 See Proposed Regulation § 1.402A-2, Q&A-2(b). 11 It is common for distributing plans to provide a direct rollover check to the participant for delivery to the recipient plan. Therefore, the Institute requests confirmation that the statement may be provided, along with the rollover check, to either the participant or the plan trustee. Internal Revenue Service April 26, 2006 Page 5 of 9 Reporting by Recipient Plan Under the proposed regulations, a plan accepting a rollover contribution (other than a direct rollover contribution) that would have been taxable to the distributee would be required to notify the Service of the acceptance of the contribution no later than the due date for filing Form 1099-R. The notice would be required to contain the employee's name, social security number, the amount rolled over, the year in which the rollover contribution was made, and any other information required by the Service in future guidance. The Institute requests that this reporting obligation be eliminated in the final regulations. Rollover contributions are not typically reported by recipient plans, and implementing this new requirement will be very costly for plans and recordkeepers. Furthermore, some Institute members report that the number of indirect rollovers received from 401(k) and 403(b) plan participants is very small. Thus, we believe the costs of this new reporting requirement would far outweigh any benefits. If this reporting rule for recipient plans is retained in the final regulations, we request extension of the deadline for providing the information to the Service. We believe additional time would be necessary because recipient plans may not be able to obtain the required information from the participant by January 31, which is the due date for furnishing Form 1099-R to participants. In addition, we request confirmation that the recipient plan

may rely on the participant's representations regarding the rollover contribution. Updates to Form 1099-R Institute members and other payors of retirement plan distributions need adequate time to establish systems for preparing Form 1099-R to report distributions and rollovers from designated Roth accounts. We recommend that the Service issue prompt guidance on the codes and other information to be required on Form 1099-R for Roth distributions. To avoid unnecessary administrative burdens, we suggest that the codes used by plans to describe distributions from designated Roth accounts parallel those used for distributions from Roth IRAs. Specifically, additional codes for the following situations would be helpful:

- Qualified Distribution from a Designated Roth Contribution Account: This code would be used for a distribution if the participant meets the five-year holding period and the participant has reached age 59-1/2, died, or become disabled (Roth IRA code equivalent = Q);
- Early Distribution from a Designated Roth Contribution Account: This code would be used for a distribution if the five-year holding period has not been met or the participant has not reached age 59-1/2, died, or become disabled (Roth IRA code equivalent = J); and

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- Direct Rollover to a Roth IRA or Another Designated Roth Contribution Account: Institute members also request that an additional, separate code be established for a direct rollover from a designated Roth account. Alternatively, instead of adding new codes for designated Roth accounts, the existing codes for Roth IRA distributions (codes J and Q) and the existing code for direct rollovers (code G) could be used for distributions from designated Roth accounts, with a new check-box in Box 7 of Form 1099-R to indicate that the distribution is from a designated Roth account. In any case, the Institute recommends that the modifications to Form 1099-R be designed to minimize necessary system changes. The preamble to the proposed regulations states that distributions from designated Roth accounts must be reported on a separate Form 1099-R, identifying the taxable amount and the first year of the individual's five-year holding period. The Institute requests that the first year of the five-year holding period not be required to be included on Form 1099-R. Including this information will require costly system changes that would seem to serve little purpose.¹²

The first year of the holding period for Roth IRAs is not reported on Form 1099-R and we urge that it not be required for designated Roth accounts.

Trustee-to-Trustee Transfers The proposed regulations do not address trustee-to-trustee transfers of designated Roth accounts, such as a transfer from one 403(b) custodian to another. In 403(b) arrangements, it is common for assets to be transferred to new trustees in this manner, rather than by rollover. Generally, trustee transfers that are not direct rollovers are not required to be reported. The Institute requests clarification that trustee transfers of designated Roth accounts are permissible under the proposed regulations. If trustee transfers of designated Roth accounts are permitted, we request confirmation that trustee transfers of designated Roth accounts are not required to be reported. In addition, we request confirmation that the participant's holding period after a trustee transfer would be determined under the same rules used for determining the participant's holding period after a direct rollover.

Hardship Distributions The proposed regulations provide that for purposes of Code section 72, a hardship distribution of Roth contributions would include a pro-rata portion of earnings, even though the entire amount distributed as a hardship withdrawal from the Roth account would be treated as elective deferrals for purposes of the limit on hardship withdrawals.¹³

¹² In a direct rollover, the plan would be required to provide this information to the recipient plan in any event. See Proposed Regulation § 1.402A-2. For distributions that are not direct rollovers, the first year of the holding period would be irrelevant because the holding period would not carry over to any plan or IRA receiving an indirect rollover. ¹³ See Proposed Regulation § 1.402A-1, Q&A-8. Internal Revenue Service April 26, 2006 Page 7 of 9

The Institute recommends changing the proposed rule so that earnings are not considered to be part of a hardship distribution from a designated Roth account. Because a

distribution on account of hardship is limited to the employee's total elective contributions as of the date of distribution (reduced by the amount of previous distributions of elective contributions)¹⁴ the otherwise applicable pro-rata distribution rule need not apply in the case of a hardship distribution. Treating a hardship distribution as including earnings for tax purposes while treating the same distribution as including only contributions for other purposes would be administratively burdensome, adding yet another layer of recordkeeping complexity to an already complicated system. It would seem to serve no tax policy purpose because the participant already has paid taxes on these contributions. This approach also will be extremely confusing to participants, who will find it hard to understand this differential treatment. Thus, we urge that the proposed rule be changed so that hardship distributions of Roth contributions are treated consistently for all purposes. If the proposed rule on hardship distributions is not changed, the Institute requests confirmation that a participant who takes a hardship distribution from a designated Roth account and subsequently receives a qualified distribution will not be taxed again on the same earnings amounts previously received as a hardship distribution. Also, for a plan that prohibits hardship withdrawals from designated Roth accounts, it is unclear whether designated Roth contributions should be considered in determining the total amount available as a hardship withdrawal from the participant's other accounts.

Universal Availability Rule The proposed regulations would apply the universal availability rule of Code section 403(b)(12) to the ability to make designated Roth contributions under a 403(b) arrangement.¹⁵ The Institute requests guidance on how the universal availability rule would apply where at least one vendor that offers investment funds to employees of a 403(b) sponsor makes designated Roth contributions available, but the other vendors do not. For example, assume a school district maintains a 403(b) arrangement and makes available three investment funds from each of three different vendors (Fund A, Fund B and Fund C). Assume that Fund A amends its custodial account agreement to accommodate Roth contributions and the school district wishes to make Roth contributions available. It is unclear whether the universal availability rule would require only that the school district make Fund A available to all employees or that Funds B and C agree to accommodate designated Roth contributions as well.

¹⁴ See Treas. Reg. § 1.401(k)-1(d)(3). ¹⁵ See Proposed Regulation § 1.403(b)-5(b)(1). Internal Revenue Service April 26, 2006 Page 8 of 9

Other Issues Needing Clarification

Automatic Rollover Rule The final regulations for Roth contributions under Code section 401(k) provide that designated Roth accounts are treated separately for purposes of the de minimis exception to the direct rollover rule,¹⁶ but do not specifically provide that designated Roth accounts are treated separately for purposes of the automatic rollover rule of Code section 401(a)(31)(B).¹⁷ As a result, plans may be required to provide automatic rollovers for Roth accounts that are under \$1,000. Separate rollovers for such small accounts would be administratively burdensome for plans and recipient trustees and custodians. Institute members would welcome guidance that permits either separate treatment of Roth accounts for purposes of applying the automatic rollover rule or transfer of small accounts to the Pension Benefit Guaranty Corporation.

Required Minimum Distributions Absent an exception, designated Roth contributions, as elective deferrals under Code section 402(g), would be subject to the required minimum distribution rules of Code section 401(a)(9). The Institute encourages the Service to provide an exception to these rules for designated Roth contributions given that individuals could avoid application of these rules during their lifetimes by rolling over their designated Roth accounts into Roth IRAs. As a matter of policy, application of the required minimum distribution rules to Roth accounts serves little purpose because qualified distributions from these accounts are not taxable. In addition, conformity with the Roth IRA rules would reduce confusion on the part of plan participants.

Make-up Contributions Under USERRA The Institute requests additional guidance relating to make-up contributions permitted

under the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) and Code section 414(u). Specifically, for make-up contributions made to designated Roth accounts, it is unclear which year is treated as the first year of the five-year holding period – the year to which the make-up contribution relates or the year in which the contribution actually is made. In addition, we request confirmation that a make-up contribution that is made in 2006 or later, but that relates to a year prior to 2006, may not be treated as a designated Roth contribution. 16 A plan is not required to offer a direct rollover of an eligible rollover distribution totaling less than \$200. Treas. Reg. § 1.401(a)(31)-1, Q&A-11. 17 See Treas. Reg. § 1.401(k)-1(f)(3)(ii). Under Code section 401(a)(31)(B), a plan that provides for mandatory distributions must transfer a participant's account into an IRA (unless otherwise instructed) if the account is over \$1,000. Internal Revenue Service April 26, 2006 Page 9 of 9 Assistance to Plan Sponsors The Service should update its model section 402(f) notice, not only to provide designated Roth contribution account distribution information, but also to incorporate discussion of the automatic rollover provisions that became effective for most plans on March 28, 2005.18 * * * The Institute would welcome the opportunity to provide further assistance to the Service in finalizing the proposed regulations. Please feel free to contact the undersigned at (202) 326-5821 with any comments or questions. Sincerely, /s/ Elena C. Barone Elena C. Barone Assistant Counsel, Pension Regulation cc: W. Thomas Reeder R. Lisa Mojiri-Azad Cathy A. Vohs 18 The Service also should consider whether the model amendment relating to automatic rollovers in Notice 2005-5 should be amended to distinguish between rollovers from designated Roth contribution accounts and rollovers from other types of plan accounts.