

Roth 401(k) Plans ... and We're Rounding Third Base!

This is a sequel to last issue's article on Roth 401(k) plans [*Roth 401(k) Features: Treasury Takes us all the Way to ... Um ... Second Base*, 13 J. Pension Benefits 3], which discussed the finalized regulations in relation to the creation of a designated Roth provision in a 401(k) plan. The IRS also issued proposed regulations in January of this year, providing additional guidance on the distribution and taxation rules for Roth accounts. These proposed regulations are discussed below.

Qualified Distributions

A significant portion of the proposed regulations discuss the criteria for a "qualified distribution." A qualified distribution is one that meets the requirements for total exclusion from taxation. If the distribution is not qualified, the earnings portion is taxed as ordinary income. You may recall that a designated Roth contribution is subject to tax as compensation income when it is earned by the participant, regardless of the fact that it is being deposited to the plan. Therefore, the principal amount of the distribution has been taxed once and has a "basis" that is not taxed again at distribution. The earnings, on the other hand, have accumulated tax-free while the funds have been in the plan. If the distribution is not qualified, those are subject to tax.

A qualified distribution is one that meets both of two criteria: the 5-Year Rule and the Distribution Event Rule.

The Five-Year Rule.

A distribution meets the 5-Year Rule if it occurs on or after the 5-taxable-year period of participation outlined in the Code and regulation (which the Code and we will call the Nonexclusion Period). This period begins on the first day of the first taxable year

in which the participant makes a designated Roth contribution to the plan, and ends when five consecutive taxable years have been completed. [Prop. Treas. Reg. §1.402A-1, Q&A-4] This period is determined separately for each plan in which the participant makes designated Roth contributions.

It is important to note that the Nonexclusion Period begins on January 1 (for a calendar year taxpayer), regardless of when during the year the participant began to make Roth contributions. So, a participant that decides to defer his Christmas bonus as his first designated Roth contribution gets a Nonexclusion Period that begins nearly 12 month earlier.

If money moves from one plan to another, it may get credit for the Nonexclusion Period completed in the distributing plan. In particular, if a direct rollover is made from one plan to another, the beginning of the Nonexclusion Period for the account in the recipient plan is the earlier of that plan's Nonexclusion Period beginning or the beginning of the Nonexclusion Period from the distributing plan. [Prop. Treas. Reg. §1.402A-1, Q&A-4(b)] Keep in mind that the only permitted recipient of a rollover from a qualified plan is a designated Roth account of another qualified plan or a Roth IRA account. [Prop. Treas. Reg. §1.402A-1, Q&A-5]

Example. Gina starts making designated Roth contributions to the ABC Plan, which is sponsored by her employer, on June 15, 2006. Gina terminates employment with ABC and starts working for DEF in 2008. She elects a direct rollover of her funds from the ABC Plan to the DEF Plan, and this is accomplished in October of 2008. Gina's first designated Roth contribution to the DEF Plan is made in January of 2009.

Because Gina did a direct rollover, she gets “tacking” of the Nonexclusion Period beginning from the ABC Plan. Therefore, her Nonexclusion Period in the DEF Plan will terminate as of December 31, 2010.

On the other hand, if Gina had an Nonexclusion Period in the recipient plan that began earlier than the distributing (ABC) plan (for example, if Gina worked previously for DEF and left her previous designated Roth contributions in the DEF Plan when she left), the ABC funds directly rolled over into the DEF Plan would get the benefit of that earlier Nonexclusion Period.

If a participant takes actual distribution of the Roth amounts and engages in a 60-day rollover, there is no tacking of the Nonexclusion Period. The Nonexclusion Period rebegins in the new plan or, if there have been designated Roth contributions made to the recipient plan, the Nonexclusion Period for the rollover amount is the same as for the other funds in the recipient plan. [Prop. Treas. Reg. §1.402A-1, Q&A-5]

Example. Carter starts making designated Roth contributions to the ABC Plan in June of 2006. She establishes a Roth IRA to which she begins making contribution in 2008. In 2009, she terminates employment with ABC and rolls over her interest in the ABC Plan designated Roth account into the Roth IRA in a 60-day rollover. The Nonexclusion Period for the funds rolled over to the Roth IRA begins January 1, 2008, for both the Roth IRA contributions and the rolled-over qualified plan funds.

In summation, the 5-Year Rule is met when the Nonexclusion Period has been completed.

The Distribution Event Rule

It is important not to confuse the Distribution Event Rule with the requirements under Code Section 401(k)(2)(B) that distributions of salary deferral contributions may not occur except under certain circumstances (specifically, death, disability, retirement, attainment of age 59½, termination of the plan without the adoption of an alternative defined contribution plan, and hardship). Code Section 401(k)(2)(B) determines when salary deferrals (including Roth amounts) may be distributed from the Plan. The Distribution Event Rule (in combination with the 5-Year Rule) determine how such distributions are taxed.

For a distribution of Roth amounts to be eligible for exclusion from income tax, the distribution must be made to a beneficiary after the participant's death, to the participant in relation to the participant's disability, or to the participant after the participant has attained age 59½. For this purpose, the disability definition is the one found in Code Section 72(m)(7) – that is, unable to engage in any substantial gainful employment expected to continue for a period of extended duration or to result in death. [Code Section 402A(d)(2)(A), referencing Code Section 408A(d)(2)(A)]

Example: Suppose Zoe is age 62 in 2008, and has been making designated Roth contributions to her employer's 401(k) plan since January of 2006. She retires in December 2008 and takes a distribution of her Roth account. This is not a qualified distribution. Although Zoe meets the requirements for the Distribution Event Rule (she is over age 59½), she has not complied with the 5-Year Rule.

Example: Suppose Jared is age 45 in 2011, and has been making designatd Roth contributions to his employer's 401(k) plan since January of 2006.

He terminates employment in December 2008 and takes a distribution of his Roth account. This is not a qualified distribution. Although Jared meets the requirements under the 5-Year Rule (the Nonexclusion Period ended on January 1, 2011), he has not complied with the Distribution Event Rule.

Taxation of Distributions That Are Not Qualified Distributions

If a distribution is not a qualified distribution, some part of it will be subject to tax. How that is determined, particularly when only part of the account is distributed, is discussed in the proposed regulations.

Complete Distributions

If the entire Roth Account is distributed to the participant, the cumulative contributions made to the account are exempt from taxation, and the cumulative earnings are taxed as ordinary income. [Prop. Treas. Reg. §1.402A-1, Q&A-3]

Partial Distributions

If only a partial distribution is made from a Roth Account, the principles of Code Section 72(e)(8) are used, and the cumulative contributions are treated as a separate contract from the cumulative earnings. Under this section, the percentage of the account that is attributable to the cumulative contributions (i.e., the “investment in the contract”) is determined. That percentage is applied to a partial distribution to determine which part of the distribution is excluded from taxation. The balance is the taxable portion. [Prop. Treas. Reg. §1.402A-1, Q&A-3, Code Section 72(e)(8)]

Rollovers

If a distribution is completely rolled over, no part of it is taxed currently. It will be taxed when it is ultimately distributed from the recipient plan or IRA.

If a distribution is partially rolled over, but the rollover is performed as a direct rollover, the amount of the rollover is considered to be first attributable to the cumulative earnings (i.e., the part that would otherwise be taxable) and only after that amount is fully accounted for will the rollover be considered to include cumulative contributions. This permits a participant to take distribution of the nontaxable portion only, rolling over what would be the taxable portion. [Prop. Treas. Reg. §1.402A-1, Q&A5(b)]

The rule is reversed if the rollover is a distribution and 60-day rollover, rather than a direct rollover. In that case, the portion that is not rolled over is considered to be first attributable to the cumulative income (i.e., the taxable portion), and only after that amount is fully distributed is any portion of the distribution attributable to the cumulative contributions (i.e., the investment in the contract. [Prop. Treas. Reg. §1.402A-1, Q&A-5(c); *see also* Example in Q&A-5(d)]

Hardship Distributions (You Might Want to Take a Stiff Drink Before You Read this Section)

Hardship distributions may be made from designated Roth Accounts. Under Treas. Reg. 1.401(k)-1(d)(3)(ii)(A), a hardship distribution may be made only from contributions and not from earnings. Therefore, you may think, clearly the hardship distribution is a nontaxable distribution, even if it is not a qualified distribution (because only Roth contributions – and not earnings – are being distributed). You are *so* naive!

The proposed regulations state, “There is *no relationship* between the accounting for designated Roth contributions as investment in the contract for section 72 and the their treatment as elective deferrals available for a hardship distribution under section 401(k)(2)(B).” [Prop. Treas. Reg. §1.402A-1, Q&A-8, emphasis added] In English, this

means, “We ain’t letting you get money out of the plan in a nonqualified distribution without paying some taxes.”

The proposed regulations bifurcate the determination of what amounts are eligible for a hardship distribution and what amounts are taxable. To properly administer a hardship distribution involving a designated Roth account, you must follow these steps:

Step #1: Determine the amount available for a hardship distribution. For this, we apply the rule under Treas. Reg. §1.401(k)-1(d)(3)(ii)(A), under which only the “principal” portion of the account is available for a hardship distribution. Therefore, the amount available is equal only to the contributions, not the earnings. Suppose, for example, that Jonathan’s account is equal to \$7,500, of which \$6,000 consists of cumulative Roth contributions and \$1,500 is cumulative income. Jonathan wants to take a \$2,500 hardship distribution. The maximum hardship distribution is the value of the cumulative contributions, or \$6,000, so Jonathan may take his desired hardship distribution.

Step #2: Determine how much of the hardship distribution is taxable. The rules under Prop. Treas. Reg. §1.402A-1, Q&A-3, are applied for taxation purposes, under which Code Section 72(e)(8) controls the taxation of the distribution: \$1,500 of the total account value of \$7,500 (20%) is earnings. Therefore, 20 percent of the amount distributed ($20\% \times \$2,500 = \500) is earnings and, therefore, taxable; the balance of \$2,000 is not taxable.

Step #3: Determine how much is available for a future hardship distribution. For this purpose, we return to the 401(k) rules. The amount of cumulative contributions before the transaction was \$6,000. We made a hardship

distribution of \$2,500. Therefore, the amount remaining for future hardship distributions is only \$3,500.