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## IRS Releases Proposed Regulations on Roth 401(k) Distributions

Last month, the IRS issued the eagerly anticipated proposed regulations regarding the taxation of Roth 401(k) contributions. The proposed regulations are generally effective January 1, 2007. These proposed regulations supplement the final Roth 401(k) regulations issued at the end of 2005. While many of the proposals were as expected, the regulations add some complexities that may be confusing to plan sponsors and participants alike. The following is a summary of the proposed regulations.

**5-year rule measured from first day of tax year:** “Qualified distributions” of Roth contributions are tax-free. To be “qualified,” the distribution must be made on or after the participant’s death, disability, or attainment of age 59½, and after the completion of five taxable years from which the first Roth contribution was made. As expected, the proposed regulations provide that this 5-year period is measured from the first day of the participant’s tax year (generally January 1) in which the first Roth contribution was made.

**How distributions trigger the 5-year clock:** Roth 401(k) contributions can be rolled over directly to a Roth Individual Retirement Account (Roth IRA) or another qualified retirement plan accepting Roth contributions. Note that Roth 401(k) distributions cannot be rolled over into a 403(b) plan even if the 403(b) plan allows for rollovers.

- If the direct rollover is made to another qualified plan, the 5-year rule begins on the earlier of the year in which the participant made Roth 401(k) contributions to either plan.
- If the direct rollover is made to a Roth IRA and the distribution is a “qualified distribution,” the entire distribution is considered basis in the Roth IRA.
- If the direct rollover is made to a Roth IRA and the distribution is not a qualified distribution, the 5-year period of the Roth IRA controls. Therefore, a participant who rolls over a nonqualified distribution to an existing Roth IRA that is more than 5 years old will get the benefit of the Roth IRA’s 5-year period. Conversely, a participant who rolls over to a new Roth IRA will lose any aging he or she had in the 401(k) plan and will have a new 5-year clock.

**60-day rollover period for distributions:** Roth 401(k) contributions that are distributed to a participant may still be rolled over into a Roth IRA within a 60-day period. If the participant chooses to roll over only a portion of the distribution, the portion that is rolled over is considered to first consist of earnings and then contributions. Once again, the 5-year period of the Roth IRA would control.

A participant also may roll over taxable amounts (nonqualified earnings) into a Roth 401(k) within a 60-day period. However, unlike a direct rollover, the 5-year period of the recipient plan will control.

**Rollovers must be Roth-to-Roth only:** A distribution from a Roth IRA may only be rolled over to another Roth IRA. Thus, amounts in a Roth IRA may not be rolled over to a qualified plan even if the Roth IRA consists entirely of amounts previously rolled over from a qualified plan.

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**Tax treatment of never-qualified distributions:** Certain distributions can never be qualified distributions, and, therefore, the earnings on these distributions are always taxable. These include:

- Distributions of deferrals in excess of the Section 402(g) limit (\$15,000 for 2006),
- Distributions in excess of the Section 415 limit (\$44,000 for 2006),
- Distributions due to a failing nondiscrimination test,
- Deemed distributions of defaulted participant loans (even if the participant would normally meet the requirements for a qualified distribution),
- The cost of current life insurance protection, and
- The pass through of dividends on employer stock (although dividends that are reinvested and subsequently distributed can be a qualified distribution).

**Substantial reporting requirements:** The proposed regulations impose significant reporting requirements on plan administrators. The plan administrator of a plan providing a direct rollover of Roth 401(k) contributions is required to provide the recipient plan administrator with a statement indicating that the distribution is a qualified distribution, or, if not, indicating the first year of the 5-year period in which the initial Roth contribution was made, and the portion of the distribution that represents basis. For a distribution that is not a direct rollover, the plan administrator must provide the participant, upon request, with the same information, other than the first year of the 5-year period. The notice must be provided no later than 30 days following the direct rollover, or upon the participant's request, as the case may be.

In addition, if a plan accepts an indirect rollover, the plan administrator must notify the IRS. The IRS will provide additional guidance as to the timing and contents of this notice.

**Formula for partial nonqualified distributions:** If a participant receives a partial distribution from a Roth 401(k) account and the distribution is not a qualified distribution, the distribution must consist of a pro-rata share of contributions and earnings. For example, if the participant has a \$5,000 Roth account balance consisting of \$4,000 of contributions and \$1,000 of earnings, and the participant takes a \$1,000 withdrawal, the withdrawal will consist of \$800 of nontaxable returned contributions and \$200 of taxable income.

**Quirky hardship withdrawal regulations:** The proposed regulations are rather quirky with regard to hardship withdrawals from a Roth 401(k) account. By law, earnings on both pre-tax and Roth 401(k) contributions are ineligible for a hardship withdrawal. Despite this, the proposed regulations require that while the maximum hardship withdrawal excludes earnings, if Roth contributions are in fact withdrawn, the actual withdrawal must consist of a pro-rata share of earnings.

For example, let's examine a participant who has a \$5,000 Roth account balance consisting of \$4,000 of contributions and \$1,000 of earnings. The maximum hardship withdrawal the participant can take is \$4,000, the principal amount of the contributions. If, however, the participant takes a \$1,000 hardship withdrawal, the withdrawal will consist of \$800 of nontaxable returned contributions and \$200 of taxable income. Despite this, the maximum amount the participant would have available for a subsequent hardship withdrawal would be \$3,000, not \$3,200.

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