

# ICI Comments on Proposal for Designated Roth Contributions, May 2005

**May 17, 2005**

Internal Revenue Service  
CC:PA:LPD:PR (REG-152354-04)  
1111 Constitution Avenue, N.W.  
Washington, DC

## **Re: Proposed Regulations Under Code Section 401(k) Concerning Designated Roth Contributions**

Ladies and Gentlemen:

The Investment Company Institute, <sup>1</sup> on behalf of its investment company members, submits these comments concerning the proposed regulations governing designated Roth contributions under section 402A of the Internal Revenue Code. <sup>2</sup> Given that such contributions are authorized beginning on January 1, 2006, the prompt finalization of these proposed regulations and resolution of related issues are critical. In particular, we strongly urge that the Service issue guidance concerning the rules governing the taxation of distributions of designated Roth contributions so that plans and their recordkeepers can establish systems and procedures to accommodate such contributions.

We therefore urge that the Service make the following suggested clarifications to the proposed regulations on an expedited schedule, with comprehensive guidance, whether in regulations or another form of official guidance, by July 1, 2005. Furthermore, we request that this guidance address both 401(k) plans and section 403(b) arrangements. The Institute also recommends that the Service assist those employers that wish to provide their employees with the ability to make designated Roth contributions by publishing model plan amendments, and issuing a revised model notice under section 402(f) of the Code.

The mutual fund industry's interest in these proposed regulations is substantial, because Institute members offer mutual fund shares as investment options under section 401(k) plans and section 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. <sup>3</sup> 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.

The following comments recommend clarifications to the proposed regulations in the areas of the separate accounting requirement, and the taxation and reporting of distributions.

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## **Separate Accounting**

Section 402A(b)(2) provides that a program shall not be treated as a qualified Roth contribution program unless the plan (1) establishes separate accounts for the designated Roth contributions of each employee and any earnings properly allocable to the contributions, and (2) maintains separate recordkeeping with respect to each account. The proposed regulations further provide that the plan must maintain a record of the employee's investment in the contract with respect to the employee's designated Roth contribution account, and must separately allocate gains, losses and other credits or charges to the designated Roth contribution account "on a reasonable and consistent basis."<sup>4</sup>

The Institute requests confirmation that the separate accounts referenced in the proposed regulations can take the form of separate recordkeeping, so long as the contributions and earnings are properly allocated and the participant's investment in the contract is maintained. In addition, we ask that the Service specifically provide that plans can maintain separate accounts that distinguish between designated Roth rollover contributions and designated Roth "direct" contributions. Such a rule would allow participants to preserve the character of their designated Roth rollover contributions and receive distributions from their designated Roth rollover accounts at any time upon request pursuant to Revenue Ruling 2004-12.<sup>5</sup>

## Plan Distributions Involving Designated Roth Contribution Accounts

The preamble to the proposed regulations notes that they do not address the taxation of the distribution of designated Roth contributions, and requests comments on this issue. The prompt resolution of these issues is particularly critical to our members' ability to establish recordkeeping and tax reporting systems before January 1, 2006. Our comments relate to both the taxation and the reporting consequences of such distributions.

## Holding Period Requirements for Qualified Distributions from Roth IRAs That Include Rollovers from Designated Roth Contribution Accounts

In order to constitute a "qualified distribution," either from a designated Roth contribution account or from a Roth IRA, the account or IRA must satisfy a five-year holding period.<sup>6</sup> The Code and proposed regulations, however, do not address the determination of the applicable holding period upon rollover from a designated Roth contribution account to an existing Roth IRA pursuant to sections 402A(c) and 408A(e) of the Code. We therefore request that the Service address the following holding period issues in future guidance.

As a threshold issue, we request confirmation that amounts from designated Roth contribution accounts can be rolled over into existing Roth IRA accounts, and need not be tracked separately from other amounts in the Roth IRA. Assuming that Roth IRAs may contain both direct contributions and these rollover amounts, we also suggest that the applicable date for measuring the five-year holding period for such a combined account should be the earlier of the following dates:

(1) the first day of the individual's taxable year for which the first regular contribution is made to any Roth IRA of the individual, or, if earlier, the first day of the individual's taxable year in which the first conversion contribution is made to any Roth IRA of the individual,<sup>7</sup> or

(2) the first taxable year for which the individual made a designated Roth contribution under the plan from which the rollover was made (or from a previous plan from which the amounts were rolled over).

The Service also should confirm in such guidance that the taxpayer is responsible for determining his or her holding period, and that the receiving Roth IRA trustee can continue to rely on the Roth IRA owner's reasonable representations in this regard.<sup>8</sup>

## Taxation of Nonqualified Distributions

Section 402A(d)(4) provides that section 72 "shall be applied separately" with respect to designated Roth accounts and other plan distributions.<sup>9</sup> Thus, the Code provision appears to require that the general taxation rules governing distributions from qualified plans will apply to nonqualified distributions from designated Roth contribution accounts.<sup>10</sup> Under this analysis, the participant's investment in the contract would be recovered on a pro-rata basis.

We note, however, that a different rule applies to nonqualified distributions from Roth IRAs under the ordering rules of section 408A(d)(4). Such distributions generally are considered to come first from contributions to the Roth IRA. Thus, under the Roth IRA rules, the participant's investment in the contract would be recovered before the amounts subject to taxation.

This potential disparity in treatment could lead sophisticated participants to receive Roth IRA distribution tax treatment of their designated Roth contribution account by rolling over their balances into Roth IRAs before taking their distributions. As a matter of tax policy, then, applying the Roth IRA distribution rules to the plan account directly would allow all participants to receive such treatment

without the necessity of a rollover to a Roth IRA. Such conformity with Roth IRA taxation rules also would reduce confusion on the part of plan participants.<sup>11</sup>

## Tax Reporting of Distributions

Institute members and other payors of retirement plan distributions also require prompt guidance in order to establish their systems for preparing IRS Form 1099-R to report distributions from designated Roth contribution accounts and direct rollovers from such accounts to similar accounts and Roth IRAs. To simplify such reporting, we suggest that the codes used by plans to describe distributions from designated Roth contribution accounts parallel those used for distributions from Roth IRAs. Specifically, we request additional codes for the following situations:

- Qualified Distribution from a Designated Roth Contribution Account: This code would be used for a distribution if the payor knows that the participant meets the five-year holding period and the participant has reached age 59-1/2, has died, or is disabled (Roth IRA code equivalent = Q);<sup>12</sup>
- Designated Roth Contribution Account Distribution, Exception Applies: This code would be used for a distribution if the payor does not know if the five-year holding period has been met, but the participant has reached age 59-1/2, has died, or is disabled (Roth IRA code equivalent = T); and
- Early Distribution from a Designated Roth Contribution Account: This code would be used if the previous two codes were not applicable (Roth IRA code equivalent = J).

Institute members also request that an additional, separate code be established for a direct rollover from a designated Roth contribution account to a Roth IRA, or to another designated Roth contribution account. This coding would prompt the sending trustee to prepare a separate Form 1099-R for the direct rollover from the designated Roth contribution account. Similarly, the code would provide verification to the receiving trustee or custodian that the rollover satisfied the rules of sections 402A(c) and 408A(e) of the Code.

## Assistance to Plan Sponsors

Many plan sponsors will need drafting assistance in order to add designated Roth contributions to their plans. First, the Service should publish model plan amendments, and confirm that those employers that use prototype plans may adopt such amendments without affecting their reliance on the prototype sponsor's opinion letter. This guidance also should address the required timing of such amendments.

Second, the Service should update its model 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.<sup>13</sup> Third, the Service should assist employers whose plans include automatic enrollment features in incorporating designated Roth contributions into such programs.

\* \* \*

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) 371-5432, or Keith Lawson, Senior Counsel, at (202) 326-5832 with any comments or questions.

Sincerely,

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cc: R. Lisa Mojiri-Azak  
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### ENDNOTES

<sup>1</sup> ICI members include 8,512 open-end investment companies (mutual funds), 650 closed-end investment companies, 143 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$7.959 trillion (representing more than 95 percent of all assets of US mutual funds); these funds serve approximately 87.7 million shareholders in more than 51.2 million households.

<sup>2</sup> The provisions appear in amendments to the final regulations under section 401(k) and 401(m) of the Code.

<sup>3</sup> *2005 Investment Company Fact Book* (45th ed.) at 40.

<sup>4</sup> Prop. Treas. Reg. § 1.401(k)-1(f)(2).

<sup>5</sup> 2004-7 I.R.B. 478. We also request confirmation that if an excess deferral under section 402(g)(2) attributable to a designated Roth contribution is not timely distributed, then the amount of the excess deferral can be added to the pre-tax elective deferral account. Under section 402A(d)(3), such an excess deferral is not treated as investment in the contract, and is included in gross income for the taxable year in which it is distributed. Thus, if such an excess deferral were required to be retained in the designated Roth contribution account, then the excess deferral amount would have to be "earmarked" in some way so that it was taxable upon distribution. Allowing these amounts to be considered along with other amounts that will be fully taxable upon distribution would simplify distributions and reporting for payors and participants.

<sup>6</sup> Code §§ 402A(d)(2) & 408A(d)(2).

<sup>7</sup> See Treas. Reg. § 1.408A-6, Q&A 2.

<sup>8</sup> Treas. Reg. § 1.408A-7, Q&A 2. We also request that similar reliance be available to retirement plan payors. See discussion below.

<sup>9</sup> This language appears to be intended to apply in this context the "separate contract" treatment applicable to after-tax contributions under section 72(d)(2). If the Service determines that the pro rata rule discussed below applies in the designated Roth contribution context, then we seek confirmation that the "separate contract" analysis applies to such amounts.

<sup>10</sup> According to the preamble, a plan may "allow an employee to elect the character of a distribution (i.e., whether the distribution will be made from the designated Roth contribution account or other accounts)," provided that the ability to so elect is set forth in the terms of the plan. The proposed regulations themselves do not address this issue; therefore, we request that the Service include discussion of the plan's ability to provide such an election in any future guidance on distribution issues.

<sup>12</sup> A similar issue arises under proposed section 1.401(k)-1(f)(3), which states that the designated Roth contribution account is subject to the rules of section 401(a)(9)(A) and (B) in the same manner as a pre-tax elective deferral account. Roth IRAs, on the other hand, are not subject to section 401(a)(9)(A). See Code § 408A(c)(5). Sophisticated participants might opt to roll over their designated Roth contribution accounts into Roth IRAs in order to shield them from the lifetime RMD rules. Others, however, might assume that the lifetime RMD rules do not apply to designated Roth contributions and potentially be disadvantaged by keeping these amounts in the plan.

<sup>13</sup> We request confirmation that the retirement plan payor may rely upon participant representations in this regard.

<sup>14</sup> 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.