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UPDATING QUALIFIED PLAN ADMINISTRATION TO OFFER ROLLOVERS TO ROTH IRAs

by

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Has your company updated its qualified plan administrative practices to reflect participants and beneficiaries' ability to roll over distributions to Roth IRAs? The Pension Protection Act of 2006 (the "PPA") **requires** that all qualified plans provide this distribution option beginning January 1, 2008. Although the PPA provides a delayed deadline for the adoption of any plan amendment necessary to reflect this rollover option, it does not obviate the need to operate a plan in a manner consistent with the PPA even before that amendment deadline. To the contrary, in fact – the ability to later rely on an amendment retroactively effective as of January 1, 2008, depends upon the Roth IRA rollover option having been offered since that date.

We understand that many companies are taking advantage of the PPA's delayed amendment deadline. As a result, they are commonly neglecting administrative changes that should occur now. The IRS recently released helpful Roth IRA rollover guidance, however, that should shift employers' focus to making sure any necessary distribution administration adjustments are made. In this newsletter, we'll briefly describe the new rollover option and suggest a few corollary administrative changes that reflect the IRS's recent guidance.

Rollovers to Roth IRAs

Prior to the PPA, a Roth IRA could only accept rollovers of amounts distributed from a traditional IRA, SIMPLE IRA, designated Roth account maintained under a 401(k) plan, or another Roth IRA. Thus, pre-tax amounts could be rolled over to a Roth IRA only through a two-step process requiring: (1) a rollover to a traditional IRA; followed by (2) converting the traditional IRA to a Roth IRA and including in gross income the amount converted. It took a similar two-step process to roll over an after-tax distribution (though there was no inclusion in gross income). The PPA cut out the middle man by expanding the list of sources for rollovers to Roth IRAs to include distributions from qualified plans, Tax Code Section 403(a) and (b) annuities, and governmental 457(b) plans.

As a result, effective January 1, 2008, qualified plan participants and at least some beneficiaries (more on this below) can roll over to a Roth IRA any "eligible rollover distribution" from a qualified plan. The PPA **requires** a qualified plan to provide this option to participants and spousal beneficiaries. A plan has the option of whether to allow *nonspousal* beneficiaries to have such a rollover made on their behalf. For purpose of the Roth IRA rollover option, an "eligible rollover distribution" is a plan distribution otherwise entitled to favorable tax treatment via a rollover prior to the PPA.

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There are, of course, tax consequences – and potential immediate tax advantages – to rolling over a distribution into a Roth IRA. Amounts being rolled over that have not been taxed (such as pre-tax deferrals to a 401(k) plan) must be included in the individual's gross income for the year in which the distribution is made. Those amounts are generally exempt, however, from the 10 percent early distribution penalty tax, so long as taxable amounts rolled into a Roth IRA are not distributed within five years of the rollover.

In 2008 and 2009, the PPA places important limitations on the Roth IRA rollover option's availability. An individual's Roth IRA may not receive such a rollover from a qualified plan if his or her modified adjusted gross income exceeds \$100,000, or if he or she is married and files separately (unless the individual lived apart from his or her spouse for the entire year). Those limits disappear beginning in 2010.

Changes in Plan Administration

Although an existing qualified plan need not be amended now (if at all; more on this at the end of this newsletter) to reflect the Roth IRA rollover option's current availability, the plan's current administration must reflect the option's availability in order for the plan to later be retroactively amended. We suggest three administrative changes that will help to show operational compliance with the PPA requirement to offer rollovers to Roth IRAs. Following a discussion of those suggestions, we will also highlight an issue for which plan administrators do not have responsibility.

Election Forms. First, plan administrators should update distribution election forms to reflect the situations in which distributees may elect to roll over amounts to Roth IRAs. This certainly includes the forms provided to participants and spousal beneficiaries, and will also include nonspousal beneficiaries' forms if a plan administrator has decided to provide that option. Incidentally, if your company is awaiting elections from individuals who have received distribution paperwork not including the Roth IRA rollover option, you may want to contact those individuals immediately and make them aware of the option.

Special Tax Notice. Second, the Section 402(f) Special Tax Notice accompanying election and distribution paperwork should be revised to explain the tax consequences of rolling over a distribution to a Roth IRA. Many companies use a model Notice promulgated by the IRS. The IRS has not updated its model Notice for several years, but recently expressed the intention to include a revised model notice in forthcoming guidance. Whether your company uses the model Notice, a derivation thereof, or an independently drafted Notice, your Notice most likely requires a significant number of changes to reflect the ability to roll amounts to a Roth IRA (as well as other distribution and rollover changes of the last several years). The best approach is to preliminarily make those changes now and then to make further desired changes after the IRS has issued a new model Notice. The IRS intends to issue a new model Notice before the end of June. Some employers may be tempted to wait for a model Notice before making any changes. To those employers we note that, at a May 2008 American Bar Association Tax Section meeting, an IRS representative suggested that the forthcoming model Notice may not even reflect the Roth IRA rollover changes. In other words, it is uncertain whether the model Notice will be worth any additional wait.

Withholding Election. Third, we suggest that individuals receive the option of electing to have taxes withheld from taxable amounts rolled over to a Roth IRA. Plan administrators that do not already provide a Form W-4P with distribution paperwork may wish to start doing so. Please note that distributees may appreciate this step because a distribution elected to be directly rolled over to a Roth IRA is not subject to mandatory withholding, even if all or a portion of the

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distribution is includible in gross income. The IRS allows a plan administrator to receive a withholding election in this context, however, and we think it to be a good practice in light of the distributee being taxed on the pre-tax amounts distributed.

Eligibility for Rollover. The IRS has made it clear that plan administrators are not responsible for a particular aspect of the rollover to a Roth IRA: ensuring that the distributee is eligible to choose such a rollover. Above, we referenced important limitations on some individuals' ability to roll over amounts to a Roth IRA in 2008 and 2009 (namely, a \$100,000 modified adjusted gross income limit and a "married filing separately" limit). Fortunately for qualified plan administrators, recent IRS guidance relieves administrators from the duty to confirm whether those limitations apply.

Closing

As referenced above, qualified plans face a delayed deadline for the adoption of PPA-related amendments: the last day of the first plan year beginning on or after January 1, 2009 (2011 for governmental plans). Some might choose to amend their plans now to more clearly satisfy ERISA's requirement that plans be administered according to their terms. Others might even argue that their plans already contain language sufficiently reflecting the right to roll over distributions to a Roth IRA, thereby eliminating the need for an amendment now or later. In any event, the administrative issues described in this newsletter require immediate attention. Moreover, the IRS has issued helpful plan administration guidance. As a result, plan administrators have little excuse to not be ready to roll with this newly effective PPA requirement.