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IRS Releases Guidance on Rollover Notices, Rollovers to Roth IRAs, Automatic Contribution Arrangements and Other Retirement Savings Incentives

The IRS recently released three revenue rulings and five notices on provisions intended to spur retirement savings. One notice provides a new model 402(f) notice for eligible rollover distributions upon termination of employment. Another notice provides guidance clarifying the rules for rollovers from qualified plans to Roth IRAs. The other guidance provides sample plan amendments for adding automatic enrollment features to 401(k) plans and SIMPLE IRAs, affirms that default contribution percentages under automatic contribution arrangements may automatically increase as employee compensation increases, and confirms that employees may be allowed to contribute the dollar equivalent of unused paid time off (PTO) into their 401(k), profit-sharing, or stock bonus plans.

Background

Under Section 402(c) of the Internal Revenue Code, eligible rollover distributions from employer retirement plans may be rolled over to eligible retirement plans. The Pension Protection Act of 2006 (PPA) specifically allowed recipients of eligible rollover distributions from non-Roth accounts in 401(k) plans to roll over these distributions to Roth IRAs. Section 402(f) requires plan administrators to provide a written explanation to participants receiving an eligible rollover distribution. Although IRS provided safe harbor notices in Notice 2002-3, they had not been updated to reflect intervening changes in the law.

PPA and Revenue Ruling 2000-8 provide rules for implementing automatic contribution arrangements in 401(k) plans, including qualified automatic contribution arrangements (QACAs) and eligible automatic contribution arrangements (EACAs). Under these arrangements, in the absence of an employee's affirmative deferral election to a tax-favored retirement plan, a default election applies under which the employee is treated as having elected to have a portion of compensation contributed to the plan rather than paid to the employee in cash. An EACA under Section 414(w) allows employees to withdraw automatic contributions no later than 90 days from the date the contributions first begin without incurring the 10% early withdrawal tax. Final regulations implementing the PPA automatic contribution provisions were issued earlier this year. (See our April 7, 2009 *For Your Information*).

Although in previously issued guidance the IRS indicated that unused vacation and sick leave pay could be contributed to a 401(k) plan, it had not published formal rulings on this point.

The IRS has now issued guidance on the above provisions that is intended to help employers implement changes and offer employees increased savings opportunities in their qualified retirement plans.

Updated Model Safe Harbor 402(f) Notices for Eligible Rollover Distributions

In Notice 2009-68 the IRS has updated the model 402(f) language previously issued in Notice 2002-3 to reflect intervening changes in the law, simplify the language, and make the benefits of rollovers more understandable to employees. The notice applies to 401(a) qualified plans, including 401(k) and defined benefit pension plans, 403(b) plans, and 457(b) plans.

There are two safe harbor explanations – one for distributions that are not from a designated Roth account and another for distributions from designated Roth accounts. Both should be provided if the participant is eligible to receive rollover distributions from both Roth and non-Roth accounts under a plan.

> ***BUCK COMMENT.*** *In its attempt to make the notice easier to read, the IRS has made it shorter than that under Notice 2002-3, but the fact that there are two notices when Roth accounts are involved may offset some of this attempt at simplification.*

The language now reflects such law changes as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), PPA, and the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART). For example, the notice now contains model language explaining the tax consequences when a 401(k) plan allows participants to roll over some or part of their eligible rollover amounts into a Roth IRA. The notice explains that a mandatory distribution of more than $1,000 must be paid in a direct rollover to an IRA if no affirmative election is made by a participant. It also explains that qualified reservist distributions, distributions made to certain qualified public safety employees under governmental plans, and distributions under an EACA within 90 days after the date automatic contributions first begin are exempt from the 10% additional income tax on early distributions. In addition, the new explanation addresses rollovers of distributions to inherited IRAs for nonspouse beneficiaries.

The safe harbor explanation may be customized by omitting information that does not apply to a particular plan or adding information consistent with Section 402(f). Any legal changes that go into effect after September 28, 2009 must also be added to the notice to remain in compliance with Section 402(f). The safe harbor explanations previously provided in Notice 2002-3, if appropriately modified to include legal changes since being issued, will continue to qualify as safe harbor notices through December 31, 2009. A plan administrator that provides the model notice to participants is deemed to have complied with the 402(f) notice requirement.

Guidance on Rollovers to Roth IRAs

In Notice 2009-75, the IRS describes the tax consequences when rollovers are made from qualified 401(a) plans, 457(b) plans, and 403(b) plans to a Roth IRA. This notice clarifies Notice 2008-30, which provided guidance on

certain distribution-related provisions of PPA, including rollovers from eligible retirement plans to Roth IRAs. (See our March 17, 2008 *For Your Information*.)

Distributions from Non-Roth Account. Notice 2009-75 says that distributions from a non-Roth account that are rolled over to a Roth IRA are includible in income in an amount equal to what would be includible if the distribution were not part of a rollover. In essence the distribution is treated as though it had been rolled over to a non-Roth IRA and immediately converted to a Roth IRA, so that the amount includible is equal to the amount rolled over, reduced by the amount of any after-tax contributions in the rollover amount.

The notice also reaffirms that an eligible rollover distribution made before January 1, 2010 may not be rolled over to a Roth IRA unless the recipient's modified adjusted gross income does not exceed $100,000, and if married, he or she files a joint federal income tax return.

> ***BUCK COMMENT.*** *Importantly, the notice specifies that a rollover to a non-Roth IRA can be made in 2009 by someone who does not meet the conditions above, and then converts to a Roth IRA in 2010.*

Distributions from Roth Account. Notice 2009-75 provides that distributions from a Roth account that are rolled over to a Roth IRA are not includible in income, whether or not the distribution is a "qualified distribution" from the Roth account – i.e., a distribution that is made after the 5-taxable year period beginning with the first taxable year for which the individual had a Roth IRA and after age 59½, on account of disability or death, or for a first-time home purchase. There are no income or joint filing restrictions for rollovers from a Roth account to a Roth IRA.

Sample Plan Amendments for Automatic Enrollment in 401(k) Plans

In Notice 2009-65, the IRS provides two sample plan amendments plan sponsors can use to add automatic enrollment and contribution features to 401(k) plans, without interfering with their ability to rely on existing favorable determination letters or the approved status of a master and prototype plan.

The first sample plan amendment is for plan sponsors to use when adding an automatic contribution arrangement. The second is to be used when adding an EACA under Section 414(w). The sample amendments do not have to be adopted verbatim and may be modified to conform to the plan's unique terms and administrative procedures.

The notice specifies that the amendments must be adopted by the later of the end of the plan year in which the amendment is effective under the discretionary amendment deadline in Revenue Procedure 2007-44 (which may be later for a governmental plan) or the PPA amendment deadline. The timeliness of the adoption must be evidenced in writing and proper notice must be provided to employees affected by the amendment within a reasonable period before it is effective.

Automatic Enrollment in SIMPLE IRAs. The IRS also released Notice 2009-66, providing guidance on facilitating automatic enrollment in SIMPLE IRA plans, and Notice 2009-67, providing a sample amendment that

may be used to add an automatic contribution arrangement to a SIMPLE IRA plan. The IRS also solicits comment on whether it should issue guidance on adding an EACA under Section 414(w) to a SIMPLE IRA plan.

Automatic Contribution Increases

In Revenue Ruling 2009-30, the IRS addresses automatic contribution "escalator" features under profit-sharing and 401(k) plans made in accordance with a plan-specified schedule and that are partly determined by increases in base pay compensation. In the first situation presented in the revenue ruling, the IRS concludes that default contribution increases do not fail to be elective contributions merely because they are in part based on the timing of increases in the participant's pay. Even though these automatic increases are not uniform percentages of plan compensation for all eligible employees and do not vary based solely on the number of years since the beginning of such eligible employees' participation in the automatic contribution arrangement, they are permissible because the underlying automatic contribution arrangement was not intended to be a QACA or EACA (both of which require uniform percentage increases). (See our April 7, 2009 *For Your Information*.) In a second fact situation, the IRS rules that that an arrangement under which default contribution percentages for all eligible employees increase on a date other than the first day of a plan year will not fail to be a QACA or an EACA.

Contributions of Paid Time Off Amounts to 401(k) or Profit-Sharing Plans

In Revenue Rulings 2009-31 and 2009-32, the IRS addresses plan amendments permitting contributions of unused paid time off to a profit-sharing plan either on an annual basis or at termination of employment. The rulings say that such amendments will not interfere with a plan's qualified status as long as the Section 401(a)(4) nondiscrimination requirements and any other applicable requirements are met. When the individual has no right to elect to take the contribution in cash under the PTO arrangement, it is considered a nonelective contribution, and when there is a right to elect cash it is considered an elective contribution. The rulings also discuss the timing of the contributions for purposes of the contribution limits under Sections 415(c) and 401(a)(30).

> ***BUCK COMMENT***. *Because the situations described in these revenue rulings are detailed and based on certain assumptions, plan sponsors considering amending their plans to permit contributions of unused paid time off to their 401(k) or profit-sharing plans should analyze their particular PTO arrangements and qualified plan provisions carefully.*

Conclusion

The recent flurry of revenue rulings and notices issued by the IRS is welcome guidance for employers that want to encourage and facilitate employee retirement savings. Buck's consultants are available to help plan sponsors sort through the details and nuances of this latest guidance.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.