



Memorandum

To: The SPARK Institute Membership
From: Larry H. Goldbrum
Date: August 15, 2011
Re: **IRS Response to SPARK Institute Questions Regarding Tax Reporting for Qualified Roth Distributions**

On February 24, 2011, The SPARK Institute asked the Internal Revenue Service (“IRS”) certain questions related to tax reporting for qualified Roth distributions from defined contribution plans. Our questions focused on statements in Q&A-6 from the Final Regulations for Designated Roth Accounts. The IRS responded to our questions through e-mail. For your convenience, the following is a restatement of the relevant sections of our letter to the IRS with their responses inserted where appropriate.

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2011 is the first year in which a distribution from a designated Roth account can be a qualified distribution. A qualified distribution is a payment that is made after attainment of age 59 1/2 (or after death or disability) and after the five-taxable-year period that begins with the first day of the taxable year in which the employee makes a designated Roth contribution. Qualified distributions are not taxable to the participant in the year of distribution.

In previous years, “code B” was used in Box 7 on Form 1099-R to identify distributions of designated Roth accounts that were not qualified. According to the 2011 Instructions for Forms 1099-R and 5498, code B is now to be used to indicate any distribution from a designated Roth account, regardless of qualification status. Our members are uncertain about how the reporting is to be accomplished.

Presumably, if a qualified distribution is made from a designated Roth account directly to the participant, one possible alternative would be to put the total amount of the distribution in Box 1, zero as the taxable amount in Box 2A, the original Roth basis in Box 5, and the first year of the designated Roth contribution (first year of the 5-taxable-year period) in Box 11. However, if a qualified distribution from a designated Roth account is directly rolled over to a Roth IRA (using code H in Box 7) or directly to a designated Roth account in another employer plan (using codes G and B in box 7), our members are unclear about how to code the distribution. Putting a zero in

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Box 2A would not provide sufficient information since the distribution would be non-taxable by virtue of the rollover, even if the distribution was not qualified.

The issue of reporting is particularly critical for a rollover to an IRA. Upon rollover, the five-taxable-year period will be tracked based on the date of the creation of the Roth IRA, which means that a subsequent distribution from the Roth IRA may not be qualified. In that case, the original amount rolled over should still be non-taxable, but subsequent earnings would be subject to taxation.

The preamble to the Final Regulations for Designated Roth Accounts under Section 402A, states:

However, the final regulations, like the proposed regulations, provide that, if a qualified distribution from a designated Roth account is rolled over into a Roth IRA, the entire amount of the distribution will be treated as basis in the Roth IRA. As a result, a subsequent distribution from the Roth IRA in the amount of the rollover would be treated as a tax-free return of basis regardless of whether the individual had maintained a Roth IRA for 5 years (although the investment return on that amount earned in the Roth IRA would not be excluded from income when distributed unless the distribution satisfied the requirements for a qualified distribution from a Roth IRA).

Detail is provided in Q&A-6, but only in reference to rollovers to designated Roth accounts in other employer plans.

Q-6. In the case of a rollover contribution to a designated Roth account, how is the amount that is treated as investment in the contract under section 72 determined?

A-6. (a) If a distribution from a designated Roth account is rolled over to another designated Roth account in a direct rollover, the amount of the rollover contribution allocated to investment in the contract in the recipient designated Roth account is the amount that would not have been includible in gross income (determined without regard to section 402(e)(4)) if the distribution had not been rolled over. Thus, if an amount that is a qualified distribution is rolled over, the entire amount of the rollover contribution is allocated to investment in the contract. (Emphasis added.)

(b) If the entire account balance of a designated Roth account is rolled over to another designated Roth account in a direct rollover, and, at the time of the distribution, the investment in the contract exceeds the balance in the designated Roth account, the investment in the contract in the distributing plan is included in the investment in the contract of the recipient plan.

Question 1: Although Q&A-6 seems to only refer to rollovers to other designated Roth accounts, is the intended solution in all rollover situations to report the total amount of the distribution in Box 1, zero as the taxable amount in Box 2A and to identify the entire amount distributed as basis in Box 5, even though it is not the amount that was originally contributed to the plan?

IRS Response 1: Report the total amount of the distribution in box 1, zero in box 2A and the entire amount of the distribution as basis in box 5 for reporting rollovers.

Question 2: Part b of the Q&A noted above also raises an important tax reporting question. It appears that when the whole account is distributed, the entire basis is recognized in reporting, even if the amount distributed is less than the basis. Does all of this Q&A-6 apply to both rollovers to a designated Roth account and to a Roth IRA?

IRS Response 2: This also applies to rollovers to a designated Roth account and to a Roth IRA. Follow the 1099R instructions rather than the 406A regulations.

Question 3: Although code B is allowed in combination with codes 7 (for distributions made after attainment of age 59½) and code 4 (for distributions made due to death), there is no provision for using code B in connection with code 3 (for distributions made due to disability). In the case of a qualified distribution of designated Roth monies in connection with disability, which of the two codes for Box 7 should take precedence?

IRS Response 3: You can use distribution code "B" or "2" (either is permissible, "2" has been recommended), or the combination "2B" to identify a qualified distribution of designated Roth monies in connection with disability. We are discussing some possible changes to the 2012 Instructions for use of distribution code 3; we have made no firm decisions at this time.

Please note that the IRS pointed out that their responses are subject to further clarification or changes in future years.

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If you have any questions about this information please feel free to contact me.

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