Internal Revenue bulletin

Bulletin No. 2007-22
May 29, 2007

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2007–34, page 1316.

LIFO; price indexes; department stores. The March 2007 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, March 31, 2007.

Rev. Rul. 2007–35, page 1317.

Revenue rulings obsolete. This ruling obsoletes Rev. Rul. 74–245, 1974–1 C.B. 124, and Rev. Rul. 82–45, 1982–1 C.B. 89, which provide guidance regarding income subject to foreign legal restrictions (also known as blocked income) under section 482. Rev. Ruls. 74–245 and 82–45 obsoleted.

Notice 2007–43, page 1318.

This notice provides guidance relating to the computation of the refueling property credit under section 30C of the Code and the treatment for purposes of the credit of converted and dual-use refueling property. The credit is available for property that is used for the storage or dispensing of alternative fuel into the fuel tank of a motor vehicle at the point where the fuel is delivered into the fuel tank of a vehicle that is propelled by the alternative fuel.

Notice 2007–44, page 1320.

LIFO; price indexes; department stores. The Service will no longer publish the Department Store Inventory Price Indexes prepared by the Bureau of Labor Statistics (BLS) but will continue to accept the BLS Department Store Inventory Price Indexes for use by department stores employing the retail and last-in, first-out (LIFO) inventory methods. Rev. Proc. 86–46 modified.

Rev. Proc. 2007–32, page 1322.

This procedure updates the Gaming Industry Tip Compliance Agreement (GITCA) Program, Rev. Proc. 2003–35, 2003–1 C.B. 919. This program allows gaming industry employers to work with the Service to create voluntary agreements establishing minimum tip rates for tipped employees in specified occupational categories. Once tip rates are established, the program allows streamlined reporting by employers to the Service with reduced need for oversight. The new procedure enhances the GITCA program to accommodate the technological changes in the gaming industry. Rev. Proc. 2003–35 superseded.

Rev. Proc. 2007–36, page 1335.

Health Savings Accounts (HSAs) inflation adjustments. This procedure modifies and supersedes section 3.24(1) of Rev. Proc. 2006–53, 2006–48 I.R.B. 996, to reflect amendments made to section 223 of the Code by the Health Opportunity Patient Empowerment Act of 2006. The Act changes the maximum annual contribution to HSAs for taxable years beginning after December 31, 2006. The procedure also provides the inflation adjusted amounts for HSAs for 2008. Rev. Proc. 2006–53, section 3.24(1), modified and superseded.

EMPLOYEE PLANS

T.D. 9324, page 1302.

Final regulations under section 402A of the Code provide guidance concerning the taxation of distributions from designated Roth accounts under qualified cash or deferred arrangements under section 401(k).

(Continued on the next page)

Finding Lists begin on page ii.
Index for January through May begins on page vi.

Department of the Treasury
Internal Revenue Service

EXEMPT ORGANIZATIONS

Notice 2007–45, page 1320.
This notice provides interim guidance on procedures for organizations exempt from federal income tax under section 501(a) of the Code and described in section 501(c)(3) to make Form 990–T available for public inspection and copying, as now required by new section 6104(d)(1)(A)(ii), enacted by the Pension Protection Act of 2006. The notice also solicits comments regarding the public inspection requirement for section 501(c)(3) organizations whose income is also exempt under section 115(l), or any other Code section or legal principle.

Announcement 2007–51, page 1337.
The IRS has revoked its determination that Security Warranty, Inc., of San Antonio, TX; Franklin Foundation, Inc., of Gaithersburg, MD; Howard Family Foundation of Chicago, IL; Center for Electronic Art of Woodacre, CA; and Richard and Jane Pater Charitable Foundation of Salt Lake City, UT, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

Announcement 2007–52, page 1337.
A list is provided of organizations now classified as private foundations.

ADMINISTRATIVE

Rev. Proc. 2007–32, page 1322.
This procedure updates the Gaming Industry Tip Compliance Agreement (GITCA) Program, Rev. Proc. 2003–35, 2003–1 C.B. 919. This program allows gaming industry employers to work with the Service to create voluntary agreements establishing minimum tip rates for tipped employees in specified occupational categories. Once tip rates are established, the program allows streamlined reporting by employers to the Service with reduced need for oversight. The new procedure enhances the GITCA program to accommodate the technological changes in the gaming industry. Rev. Proc. 2003–35 superseded.

Announcement 2007–50, page 1337.
This document contains corrections to final and temporary regulations (T.D. 9322, 2007–18 I.R.B. 1100) that provide guidance to corporations filing consolidated returns.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 402A.—Optional Treatment of Elective Deferrals as Roth Contributions

26 CFR 1.402A–1: Designated Roth accounts.

T.D. 9324

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1 and 602

Designated Roth Accounts Under Section 402A

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations under sections 401(k), 402(g), 402A, and 408A of the Internal Revenue Code (Code) relating to designated Roth accounts. These final regulations provide guidance concerning the taxation of distributions from designated Roth accounts under qualified cash or deferred arrangements under section 401(k). These final regulations will affect administrators of, employers maintaining, participants in, and beneficiaries of section 401(k) and section 403(b) plans, as well as owners and beneficiaries of Roth IRAs and trustees of Roth IRAs.

DATES: *Effective Date:* These final regulations are effective *April 30, 2007*.

Applicability Date: These regulations generally apply to taxable years beginning on or after January 1, 2007. For dates of applicability, see §§1.401(k)–1(f)(6), 1.402A–1, A–15, 1.402A–2, A–4 and 1.408A–10, A–6.

FOR FURTHER INFORMATION CONTACT: R. Lisa Mojiri-Azad or William D. Gibbs at 202–622–6060, or Cathy A. Vohs, 202–622–6090 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations was reviewed and approved by the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number OMB–1545–1992.

The collection of information in these final regulations is in 26 CFR §1.402A–2. This information is required to comply with the separate accounting and recordkeeping requirements of section 402A. This information will be used by the IRS and employers maintaining designated Roth accounts to insure compliance with the requirements of section 402A. The collection of information is required to obtain a benefit. The likely recordkeepers are state or local governments, business or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

The estimated annual burden per respondent under control number OMB–1545–1992 is 2.3 hours.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains final regulations under section 402A, and amendments to regulations under sections 401(k), 402(g), and 408A of the Internal Revenue Code. Section 402A, which sets forth rules for designated Roth contributions, was added to the Code by section 617(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (115 Stat. 103) (EGTRRA), effective for taxable years beginning after December 31, 2005. These final regulations also reflect certain provisions of the Pension Protection Act of 2006, Public Law 109–280, (120 Stat. 780) (PPA '06), including section 811 of PPA '06, which repealed the sunset provisions of EGTRRA with respect to section 402A.

Section 401(k) sets forth rules for qualified cash or deferred arrangements under which an employee may make an election between cash and an employer contribution to a plan qualified under section 401(a). Section 403(b) permits a similar salary reduction agreement under which payments are made to a section 403(b) plan. Section 402(e)(3) provides that an amount is not includible in an employee's income merely because the employee has an election whether these contributions will be made to the trust or annuity or received by the employee in cash.

Amounts contributed pursuant to these qualified cash or deferred arrangements and salary reduction agreements are defined in section 402(g)(3) as elective deferrals. Section 402(g)(1) provides a limit on the amount of elective deferrals that may be excluded from an employee's income for a taxable year. Section 402(g)(2) provides for the distribution of elective deferrals that exceed the annual limit on elective deferrals (an excess deferral).

A designated Roth contribution is an elective deferral, as described in section 402(g)(3)(A) or (C), that has been designated by an employee, pursuant to section 402A, as not excludable from the employee's gross income. Under section 402A(b)(2), designated Roth contributions must be maintained by the plan in a separate account (a designated Roth account).

Under section 402(a), a distribution from a plan qualified under section 401(a) is taxable under section 72 to the distributee in the taxable year distributed. However, pursuant to section 402A(d)(1), a qualified distribution from a designated Roth account is excludable from gross income. A qualified distribution is defined in section 402A(d)(2) as a distribution that is made after completion of a specified 5-year period and the satisfaction of other specified requirements.

If the distribution is not a qualified distribution, pursuant to section 72, the distribution is included in the distributee's gross income to the extent allocable to income on the contract and excluded from gross income to the extent allocable to investment in the contract (basis). The amount of a distribution allocated to investment in the contract is generally determined by applying to the distribution the ratio of the investment in the contract to the account balance.

Section 402(c) provides rules under which certain distributions from a plan qualified under section 401(a) may be rolled over into another eligible retirement plan. In such a case, the distribution is not currently includible in the distributee's gross income. Under section 402(c)(2), as amended by section 822 of PPA '06, to the extent some or all of the distribution from a plan qualified under section 401(a) would not have been includible in gross income if it were not rolled over, that portion of the distribution can only be rolled over into an individual retirement plan, or through a direct rollover to another qualified plan or section 403(b) plan that agrees to separately account for such rolled over amounts. Section 403(b)(8)(B) provides that the rules of section 402(c)(2) also apply for purposes of the rollover rules under section 403(b)(8).

Under section 402(c)(8) and 402A(c)(3), a distribution from a designated Roth account can be rolled over only to another designated Roth account or to a Roth IRA. Under section 408A, a Roth IRA is a type of individual retirement plan (IRA) under which contributions are never deductible and qualified distributions are excludable from gross income. Section 408A(d)(4) sets forth special ordering rules for the return of basis in the case of a distribution from a Roth IRA. Under the section 408A(d)(4) ordering rules, in a nonqualified distribution from a Roth IRA, basis is recovered before income.

Section 617(d) of EGTRRA amended section 6051(a)(8) to require the reporting of designated Roth contributions on Form W–2, "*Wage and Tax Statement*," and added a new subsection (f) to section 6047 to require plan administrators or other responsible persons of section 401(k) or 403(b) plans to make such returns and reports regarding designated Roth contributions to the Secretary of the Treasury and such other persons the Secretary may prescribe.

Final regulations under section 401(k) were issued on December 29, 2004 (69 FR 78144). Those final regulations reserved §1.401(k)–1(f) for special rules for designated Roth contributions. On January 3, 2006, final regulations were issued that fill in that reserved paragraph and provide additional rules applicable to designated Roth contributions (71 FR 6). The provisions of the final regulations under section 401(k) regarding designated Roth contributions do not address the taxability of distributions from designated Roth accounts or the reporting requirements that apply to contributions of designated Roth contributions or distributions from the accounts.

On January 26, 2006, a notice of proposed rulemaking (REG–146459–05, 2006–8 I.R.B. 504) under section 402A was published in the **Federal Register** (71 FR 4322). The proposed regulations also would have provided guidance with respect to designated Roth contributions under section 403(b) plans by amending the proposed regulations (REG–155608–02, 2004–2 C.B. 924) under section 403(b), published in the **Federal Register** on November 16, 2004 (69 FR 67075). This guidance has not been finalized in this Treasury Decision, but will instead be included in the final regulations under section 403(b). Written comments responding to the notice of proposed rulemaking under section 402A were received. A public hearing was held on July 26, 2006. After consideration of all comments, these final regulations adopt the provisions of the proposed regulations with certain modifications, the most significant of which are highlighted below.

These final regulations under section 402A are intended to provide comprehensive guidance on the taxation of distributions from designated Roth accounts under section 401(k) and section 403(b) plans. These regulations also provide guidance on the reporting requirements with respect to these accounts and include amendments to the provisions of the final section 401(k) regulations relating to designated Roth contributions. In addition, these final regulations include amendments to the regulations under section 402(g) issued in 1991 in order to reflect the enactment of section 402A (as well as other statutory changes since those regulations were issued) and to make changes to conform the regulations under section 402(g) to the final section 401(k) regulations. These final regulations also add a new §1.408A–10 to the existing regulations under section 408A for Roth IRAs (§1.408A–1 through 9) issued in 1999 to reflect the interaction between section 408A and section 402A.

Explanation of Provisions

Overview

These final regulations, like the proposed regulations, provide guidance on the taxation of distributions from designated Roth accounts and other related issues. A designated Roth account is a separate account under a section 401(k) plan or section 403(b) plan to which designated Roth contributions are made, and for which separate accounting of contributions, gains, and losses are maintained. These final regulations retain the rule from the proposed regulations that any transaction or accounting methodology involving an employee's designated Roth account and any other accounts under the plan or plans of an employer that has the effect of directly or indirectly transferring value from another account into the designated Roth account violates the separate accounting requirement under section 402A.

The taxation of a distribution from a designated Roth account depends on whether or not the distribution is a qualified distribution. A qualified distribution from a designated Roth account is not includible in the employee's gross income. A qualified distribution is generally a distribution that is made after a 5-taxable-year period of participation and that either (1) is made on or after the date the employee attains age 59½, (2) is made after the employee's death, or (3) is attributable to the employee's being disabled within the meaning of section 72(m)(7). In response to comments, these final regulations clarify that, in the case of distribution to an alternate payee or beneficiary, the age, death or disability of the participant are used to determine whether the distribution is qualified. The only exception is in the case of a rollover by an alternate payee or surviving spouse to a designated Roth account under a plan of his or her own employer.

Determination of 5-Taxable-Year Period for Qualified Distributions

In order for a distribution from a designated Roth account to be a qualified distribution and thus not includible in gross income, a 5-taxable-year requirement must be satisfied. These final regulations, like the proposed regulations, reflect the rule in section 402A that the 5-taxable-year period during which a distribution is not a qualified distribution begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the plan and ends when 5 consecutive taxable years have been completed. However, if a direct rollover is made from a designated Roth account under another plan, the 5-taxable-year period for the recipient plan begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the other plan, if earlier.

Commentators inquired as to when designated Roth contributions made by a reemployed veteran for a year of qualified military service pursuant to section 414(u), are treated as made for purposes of the 5-taxable-year period of participation. In response to these comments, the final regulations provide that designated Roth contributions made by a reemployed veteran are treated as made in the taxable year with respect to which the contributions relate. Reemployed veterans may identify the year for which a contribution is made for other purposes, such as for entitlement to a match, and the treatment for the five year period of participation rule follows that identification. Absent such an identification, for purposes of determining the first year of the five years of participation under section 402A(d)(2)(B), the contribution is treated as made in the veteran's first taxable year in which the veteran's qualified military service begins, or if later, the first taxable year in which designated Roth contributions could be made under the plan.

Commentators asked how the 5-taxable-year period of participation rule applies to a required minimum distribution made for an earlier year, such as a distribution made on April 1 following the year an employee attains age 70½. They also asked whether, if payments under an annuity stream commence before a qualifying event, the payments after the qualifying event could be qualified distributions (assuming the 5-year period of participation is satisfied). The determination of whether a payment is a qualified distribution is determined based upon the actual year of the payment from the account and does not take into account whether the payment is part of a series of distributions or whether the payment is attributable to a prior calendar year.

In response to comments, these final regulations provide that certain contributions do not start the 5-taxable-year period of participation. For example, a year in which the only contributions consist of excess deferrals will not start the 5-taxable-year period of participation. Further, excess contributions that are distributed to prevent an ADP failure also do not begin the 5-taxable-year period of participation. Finally, contributions returned to the employee pursuant to section 414(w) also do not start the 5-taxable-year period of participation.

Taxation of Nonqualified Distributions

These final regulations retain the rules from the proposed regulations for taxation of nonqualified distributions and provide that a distribution from a designated Roth account that is not a qualified distribution is taxable to the distributee under section 402 (or section 403(b)(1)), treating the designated Roth account as a separate contract under section 72. In applying that treatment, the portion of any distribution that is includible in gross income as an amount allocable to income on the contract and the portion not includible in income as an amount allocable to investment in the contract is generally determined under section 72(e)(8) (or, in the case of an amount received as an annuity, section 72(b) or (d), as applicable).

Some commentators requested that the special ordering rules in section 408A(d), which provide that the first distributions from a Roth IRA are a return of contributions (and thus not includible in gross income) until all contributions have been returned as basis, be applied to distributions from a designated Roth account. They noted that a *pro rata* basis recovery rule in section 72 is difficult to explain to employees receiving a hardship distribution from a designated Roth account because the entire distribution reduces the amount of elective contributions (including designated Roth contributions) available for hardship distribution while, for purposes of determining the amount includible in income under sections 402(a) and 72, only a portion of the distribution is treated as recovery of basis attributable to the designated Roth contributions.

As noted in the preamble to the proposed regulations, because section 402A does not provide that the special ordering rules of section 408A(d) apply to distributions from designated Roth accounts, these final regulations do not apply those special ordering rules. Although designated Roth contributions to a designated Roth account bear some similarity to contributions to a Roth IRA (*e.g.*, contributions to either type of account are after-tax contributions, and qualified distributions from either type of account are excludable from gross income), there are many differences between these types of arrangements. The only special rule under section 402A for nonqualified distributions from a designated Roth account is that the account is treated as a separate contract for purposes of section 72.

Thus, these final regulations do not apply the basis recovery rules in section 408A to distributions from designated Roth accounts. Furthermore, the limit on elective contributions available for hardship distribution is an aggregate limit that takes into account both pre-tax elective contributions and designated Roth contributions. For example, an employee could take all hardship distributions from the pre-tax account, even though part of the amount available for hardship is attributable to designated Roth contributions. Thus, the amount of elective deferrals available for distribution from a designated Roth account on account of hardship generally would be a different amount than the total designated Roth contributions even if the ordering rule in section 408A(d)(4) applied to distributions from designated Roth accounts.

Rollover of Designated Roth Contributions

As described above in the Background section of this preamble, section 402(c)(2), after amendment by section 822 of PPA '06, provides that, if a portion of the distribution from a plan qualified under section 401(a) is not includible in income (determined without regard to the rollover), that portion of the distribution can only be rolled over by a direct rollover of the distribution to another qualified plan, or to a section 403(b) plan, that provides for separate accounting for amounts transferred (and earnings thereon) including separate accounting for the portion of such distribution which is includible in gross income and the portion of such distribution that is not so includible. Alternatively, the distribution can be rolled over to an IRA in either a 60-day rollover or direct rollover.

Section 402A(c)(3) provides that a rollover contribution of a distribution from a designated Roth account may only be made to the extent it is otherwise allowable. Section 402(c)(2) provides rules regarding when a rollover contribution of amounts not includable in gross income are allowable. As noted in the preamble to the proposed regulations, the IRS and Treasury Department believe that the rules in section 402(c)(2) relating to the rollover of a distribution of an amount not includable in gross income apply to a distribution from a designated Roth account.[1] Thus, these regulations retain the rule in the proposed regulations that, in order to roll over any portion of the basis in a designated Roth account into a designated Roth account under another plan, the rollover of the distribution must be accomplished through a direct rollover (*i.e.*, a rollover to another designated Roth account is not available for the portion of the distribution not includible in gross income if the distribution is made directly to the employee). However, for purposes of these regulations, the requirement that the receiving plan separately account for designated Roth contributions that are rolled over has been eliminated because such contributions are independently subject to the separate account requirement of Treas. Reg. §1.401(k)–1(f).[2]

In response to comments, the final regulations clarify that, for purposes of these regulations, if any amount is paid as a direct rollover, that amount is treated as a separate distribution from any amount paid directly to the distributee for purposes of applying section 402(c)(2). Finally, to insure that there is proper accounting in the recipient plan, as described under the heading *Reporting and Recordkeeping*, these final regulations retain the provision in the proposed regulations requiring the distributing plan making the direct rollover is required to report the amount of the investment in the contract and the first year of the 5-year period to the recipient plan so that the recipient plan will not need to rely on information from the distributee.

In response to comments, the definition of designated Roth account has been revised to clarify that the definition only includes accounts under a plan to which designated Roth contributions are made in lieu of elective contributions or deferrals. Thus, the final regulations clarify that a distribution from a designated Roth account may only be rolled over to a section 401(k) plan or section 403(b) plan if that has a designated Roth program.

As in the proposed regulations, the final regulations provide that if the entire amount of a distribution from a designated Roth account is rolled over to another designated Roth account, 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. In response to comments, the final regulations clarify that, if the entire account balance of a designated Roth account is rolled over to another designated Roth account, 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.[3]

If a distribution from a designated Roth account is made to an employee, the employee is still able to roll over the entire amount (or any portion thereof) into a Roth IRA within a 60-day period. Under section 402(c)(2), if only a portion of the distribution is rolled over, the portion that is rolled over is treated as consisting first of the amount of the distribution that is includible in gross income. These final regulations, like the proposed regulations, provide that the income limits for contributions for Roth IRAs do not apply for this purpose.

Alternatively, the proposed regulations provided that the employee is permitted to roll over the taxable portion of the distribution to a designated Roth account within a 60-day period. In such a case, additional reporting is required from the recipient plan, as described below under the heading *Reporting and Recordkeeping*. In addition, the employee's period of participation under the distributing plan is not carried over to the recipient plan for purposes of determining whether the employee satisfies the 5-taxable-year requirement under the recipient plan. Commentators objected to this different treatment for indirect rollover contributions claiming that it reduces portability. The IRS and Treasury Department believe that this rule is more consistent with the statutory language and will further encourage direct rollover of distributions from designated Roth accounts which will reduce leakage of these distributions from retirement savings solution. Thus, this rule is retained in the final regulations. However, the final regulations provide that such an indirect rollover contribution starts the 5-taxable-year period of participation under the receiving plan for a participant who has made no prior designated Roth contributions to that plan.

Determination of 5-Taxable-year Period after a Rollover to a Roth IRA

Section 402A and section 408A each provide for a 5-taxable-year period that must be completed in order for a distri-

[1] For distributions from designated Roth accounts, there is the same need for proper accounting of investment in the contract as for distributions from other accounts that include after-tax contributions. In addition, it is necessary to track whether the employee has satisfied the 5-year rule for qualified distributions.

[2] The proposed regulations would have reflected the rule in section 402(c)(2) prior to amendment by PPA '06 that limited rollovers of distributions from qualified plans that are not includible in gross income to direct rollovers to other qualified trusts and not to section 403(b) plans. These final regulations do not retain this restriction on rollovers because of the amendments to section 402(c) made by section 822 of PPA '06.

[3] If the investment in the contract exceeds the account balance and the entire account balance is distributed (and not rolled over), see Rev. Rul. 72–305, 1972–1 C.B. 116, for guidance concerning a deduction for the difference.

bution from a designated Roth account or a Roth IRA to be a qualified distribution. However, each of these sections contains different rules for determining when the 5-taxable-year requirement is satisfied. Generally, under section 402A, satisfaction of the 5-taxable-year requirement with respect to a designated Roth account under a plan is based on the years since a designated Roth contribution was first made by the employee under that plan. In contrast, the 5-year period under section 408A begins with the first taxable year for which a contribution is made to any Roth IRA.

Commentators suggested that, if a distribution from a designated Roth account to an individual is rolled into a Roth IRA, the individual receive credit under the 5-year rule in section 408A for the years since the individual first made a contribution to a designated Roth account. As noted in the preamble to the proposed regulations, the IRS and Treasury Department do not believe that the Code provides for this interaction between the two 5-year rules. Thus, these final regulations retain the rule under the proposed regulations that the 5-taxable-year period described in section 402A and the 5-taxable-year period described in section 408A(d)(2)(B) are determined independently. Thus, in the case of a rollover of a distribution from a designated Roth account maintained under a section 401(k) or 403(b) plan to a Roth IRA, the final regulations, like the proposed regulations, provide that the period that the rolled-over funds were in the designated Roth account does not count towards the 5-taxable-year period for determining qualified distributions from the Roth IRA. However, if an individual had established a Roth IRA in a prior year, the 5-year period for determining qualified distributions from a Roth IRA that began as a result of that earlier Roth IRA contribution applies to any distributions from the Roth IRA (including a distribution of an amount attributable to a rollover contribution from a designated Roth account).

If a nonqualified distribution from a designated Roth account is rolled over into a Roth IRA, the portion of the distribution that constitutes a nontaxable return of investment in the contract is treated as basis in the Roth IRA. 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). Similar to the case of a rollover to a designated Roth account, if the entire account balance of a designated Roth account is distributed and some or all of the distribution is rolled over to a Roth IRA, 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 amount treated as a contribution to the Roth IRA.

Certain Amounts not Qualified Distributions

Section 1.402(c)–2, A–4, provides a list of amounts that are not treated as eligible rollover distributions and are instead currently includible in income. These final regulations, like the proposed regulations, provide that these same amounts also cannot be qualified distributions. Distributions described in A–4(a) (distribution of elective deferrals in excess of the section 415 limits), (b) (corrective distribution of excess deferrals), and (c) (corrective distribution of excess contributions or excess aggregate contributions), have statutorily specified tax treatments. In the case of a deemed distribution under section 72(p) or the cost of current life insurance protection, an actual amount has not in fact been distributed. In the case of distributions of dividends deductible under section 404(k), section 72(e)(5)(D) and §1.404(k)–1T provide that these amounts are treated as paid under a separate contract providing only for payment of deductible dividends. However, if a dividend described in section 404(k) has been reinvested in accordance with section 404(k)(2)(iii)(II), then a distribution of the reinvested amount can be a qualified distribution.

In response to comments regarding hardship distributions, the final regulations clarify that an amount is not precluded from being a qualified distribution merely because it is described in section 402(c)(4) as an amount not eligible for rollover. Thus, hardship distributions and required minimum distributions are not precluded from being qualified distributions. Similarly, payments in a stream of periodic payments are not precluded from being qualified distributions merely because they are described in section 402(c)(4)(A).

Distribution of Employer Securities and NUA

The final regulations retain the rules of the proposed regulations relating to the distribution of employer securities and the application of the net unrealized appreciation election of section 402(e)(4). If a qualified distribution includes employer securities, the distribution is not includible in gross income and the basis of each security in the hands of the distributee is the fair market value of the security on the date of the distribution. In such a case, the distributee will receive capital gains treatment at the time of any future disposition of the security, to the extent of any post-distribution appreciation. If a distribution with respect to employer securities is not a qualified distribution, the rules of section 402(e)(4) apply in the same manner as to any other distribution except that the designated Roth account is treated as a separate contract.

Some commentators inquired how these rules apply to the portion of a nonqualified distribution that exceeds the basis of the employer stock at the time of the distribution to the extent not includible in gross income as a return of the employee's designated Roth contributions. As explained in Rev. Rul. 74–398, 1974–2 C.B. 136, the basis of the stock at the time of the disposition will be increased to reflect such amount, so that such amount will not be subsequently taxed as appreciation at the time of a subsequent disposition of the stock.

Annuity contracts

As noted above, in the *Overview* section of this preamble, these final regulations retain the rule from the proposed regulations that any transaction or accounting methodology involving an employee's designated Roth account and any other accounts under the plan or plans of an employer that has the effect of directly or indirectly transferring value from another account into the designated Roth account violates the separate accounting requirement under section 402A. Commentators asked for additional guidance on how this requirement is satisfied for separate accounts maintained within a single annuity contract, in particular how to allocate charges for guarantees under the contract which apply to the total of all accounts under the contract. The IRS and Treasury Department believe that it may be difficult for a single contract to have combined guarantees that apply to both accounts without the potential for a prohibited transfer of value between the accounts, and have not issued guidance on how to account for these guarantees (including related charges). However, this issue will continue to be considered by the IRS and Treasury Department. Therefore, the regulations authorize the Commissioner to provide additional guidance with respect to separate accounting within an annuity contract.

In response to comments, these final regulations clarify that, as previously indicated in §1.402(c)–2, A–10(a), a distribution of an annuity contract from a designated Roth account is not a distribution event for purposes of section 402 or 402A. Thus, in such case, only distributions from the annuity contract are treated as distributions for those purposes. The determination of whether a distribution is a qualified or nonqualified distribution is made at the time of the distribution from the contract.

Reporting and Recordkeeping

These final regulations retain the rule of the proposed regulations that the plan administrator or other responsible party with respect to a plan with a designated Roth account is responsible for keeping track of the 5-taxable-year period for each employee and the amount of designated Roth contributions made on behalf of such employee. In addition, the plan administrator or other responsible party of a plan directly rolling over a distribution is required to provide the plan administrator of the recipient plan (that is, the plan accepting the eligible rollover distribution) with a statement indicating either the first year of the 5-taxable-year period for the employee and the portion of such distribution attributable to basis or that the distribution is a qualified distribution. If the distribution is not a direct rollover to a designated Roth account under another eligible plan, the plan administrator or responsible party must provide to the employee, upon request, this same information, except the statement need not indicate the first year of the 5-taxable-year period. The statement is required to be provided within a reasonable period following the direct rollover (or employee request), but in no event later than 30 days following the direct rollover (or employee request), and the plan administrator or other responsible party for the recipient plan is permitted to rely on these statements. If this information is provided on a statement attached to the check issued to the employee, this requirement would be satisfied.

As noted in the preamble, to the extent that a portion of a distribution is includible in income (determined without regard to the rollover), if any portion of that distribution is rolled over to a designated Roth account by the distributee rather than by direct rollover, the plan administrator of the recipient plan must notify the IRS of its acceptance of the rollover contribution. The final regulations clarify that this reporting is only required to the extent provided in Forms and Instructions. Such Instructions will specify the address to which the notification must be sent and will require the following information: (1) the employee's name and social security number; (2) the amount rolled over; (3) the year in which the rollover contribution was made; and (4) such other information as the Commissioner may prescribe in order to determine that the amount rolled over is a valid rollover contribution. Thus, until relevant Forms and Instructions are released, no reporting is required.

With respect to other reporting, generally, the same reporting requirements apply to plans with designated Roth accounts as apply to other plans. A contribution to and a distribution from a designated Roth account must be reported on Form W–2 and Form 1099–R, "*Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*," respectively, in accordance with the instructions thereto. An employee has no reporting obligation with respect to designated Roth contributions under a section 401(k) or 403(b) plan. However, an employee rolling over a distribution from a designated Roth account to a Roth IRA should keep track of the amount rolled over in accordance with the instructions to Form 8606, "*Nondeductible IRAs*."

Designated Roth Contributions as Excess Deferrals

Even though designated Roth contributions are not excluded from income when contributed, they are treated as elective deferrals for purposes of section 402(g). Thus, to the extent total elective deferrals for the year exceed the section 402(g) limit for the year, the excess amount can be distributed by April 15th of the year following the year of the excess without adverse tax consequences. However, if such excess deferrals are not distributed by April 15th of the year following the year of the excess, these final regulations, like the proposed regulations, provide that any distribution attributable to an excess deferral that is a designated Roth contribution is includible in gross income (with no exclusion from income for amounts attributable to basis under section 72) and is not eligible for rollover. These regulations provide that if there are any excess deferrals that are designated Roth contributions that are not corrected prior to April 15th of the year following the excess, the first amounts distributed from the designated Roth account are treated as distributions of excess deferrals and earnings until the full amount of those excess deferrals (and attributable earnings) are distributed.

Gap Period Income

In addition, these final regulations retain the rule in the proposed regulations which reflected the statutory provisions which require that any distribution of excess deferrals include the applicable earnings from the plan. Unlike the existing final regulations under section 402(g), the earnings include income for the period after the taxable year (gap period income). The calculation of gap period income is comparable to the calculation of the gap period income for excess contributions and excess aggregate contributions under the 2004 final regulations under section 401(k) and 401(m). Thus, gap period income must be included in the distribution of excess deferrals to the extent the employee is or would be credited with allocable gain or loss on those excess deferrals for the gap period if the total account were to be distributed. This gap period income rule applies to both pre-tax excess deferrals and designated Roth contributions and continues to apply even after the 2008 elimination of the rule for excess contributions and excess aggregate contributions under section 902(e)(3) of PPA '06.

Modifications to Final Roth 401(k) Regulations

Some comments received in connection with the proposed regulations raised concerns not about those regulations but rather about the special rules for designated Roth contributions in §1.401(k)–1(f) that were finalized in T.D. 9237, 2006–6 I.R.B. 394, published on January 3, 2006 (71 FR 6). In response to those comments these final regulations make two changes to those special rules. First, these regulations clarify and expand the rule in §1.401(k)–1(f)(3)(ii) to provide that the balance of a participant's designated Roth account and a participant's other accounts under the plan are treated as accounts held under two separate plans (within the meaning of section 414(l)) for purposes of applying not only the special rule in A–11 of §1.401(a)(31)–1 for *de minimis* distributions (reasonably expected to total less than $200) but also both the automatic rollover rules for mandatory distributions under section 401(a)(31)(B) and the rules in A–9 and A–10 of §1.401(a)(31)–1 on the extent to which plans must allow split distributions. Thus, for example, if a participant has less than $1,000 in the participant's designated Roth account and less than $1,000 in the participant's other accounts, the plan will not need to provide the participant with an automatic rollover with respect to the designated Roth account or the other accounts even if the total accrued benefit of the participant under the plan exceeds $1,000.

Second, in response to comments about compensation provided to certain foreign missionaries, the regulations are modified to require that an employer treat designated Roth contribution as not excludible from gross income as elective deferrals rather than treated as includible in gross income. As a result, if section 72(f)(2) applies to a contribution, an employee will have basis as a result of the contribution to the extent that contribution would have been excludible from gross income even if paid directly to the employee and such amount can be treated as a designated Roth contribution even though such amount is income that is not includible in taxable income. Thus, compensation for foreign missionaries is not precluded from being contributed to a designated Roth account merely because the compensation would not have been includible in gross income if paid directly. Finally, the regulations clarify that, for self-employed individuals, the requirement that a designated Roth contribution not be excludible from gross income as an elective deferral for being a designated Roth contribution is only satisfied if the self-employed individual does not claim a deduction for the contribution.

Commentators inquired as to whether catch-up contributions may be designated Roth contributions. Catch-up contributions are treated the same as any other elective deferrals and, thus, a participant's catch-up contributions may either be pre-tax elective deferrals or designated Roth contributions.

Finally, these final regulations revise the special rules for designated Roth contributions in §1.401(k)–1(f) to reflect the repeal in PPA '06 of the sunset of the provisions relating to designated Roth contributions.

Effective Date

Section 402A applies to employees' taxable years beginning on or after January 1, 2006. These final regulations under section 402A are generally applicable for taxable years beginning on or after January 1, 2007. However, certain provisions in these final regulations under section 402A are applicable at the same time as section 402A. These include the clarification that the separate accounting requirement does not permit any transaction or accounting methodology that transfers value between designated Roth accounts and other accounts under a plan and the rules relating to rollovers to designated Roth accounts and Roth IRAs. Similarly, these final regulations under section 408A are applicable at the same time as section 402A. These final regulations also address the treatment of rollover contributions to Roth IRAs and designated Roth accounts.

The final regulations under section 402(g) relating to designated Roth contributions also are applicable at the same time as section 402A. Thus, these final regulations are applicable for excess deferrals for taxable years beginning on or after January 1, 2006. However, unlike the proposed regulations, the rule in these final regulations requiring distribution of gap period income on excess deferrals applies to excess deferrals for taxable years beginning on or after 2007, which are generally distributed on or after January 1, 2008.

Special Analyses

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that 5 U.S.C. 553(b) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that most small entities that will maintain a designated Roth account already use a third party provider to administer the plan and the collection of information in these regulations, which is required to comply with the separate accounting and recordkeeping requirements of section 402A(b), will only minimally increase the third party provider's administrative burden with respect to the plan. Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are R. Lisa Mojiri-Azad, Bill Gibbs and Cathy Vohs, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in the development of these regulations.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.402A–1 is also issued under 26 U.S.C. 402A * * *

Par. 2. Section 1.401(k)–0 is amended as follows:

1. The entry for 1.401(k)–1(f)(2), (3), (4) and (5) are revised.
2. The entry for 1.401(k)–1(f)(6) is added.

§1.401(k)–0 Table of contents.

* * * * *

§1.401(k)–1 Certain cash or deferred arrangements.

* * * * *

(f) * * *

(1) In general.

(2) Inclusion treatment.

(3) Separate accounting required.

(4) Designated Roth contributions must satisfy rules applicable to elective contributions.

(i) In general.

(ii) Special rules for direct rollovers.

(5) Rules regarding designated Roth contribution elections.

(i) Frequency of elections.

(ii) Default elections.

(6) Effective date.

Par. 3. Section 1.401(k)–1(f) is amended as follows:

1. Revise paragraph (f)(1)(ii) and (iii).
2. Redesignate paragraph (f)(2) thru (f)(5) as (f)(3) thru (f)(6).
3. Add a new paragraph (f)(2).
4. Revise the first sentence of designated paragraph (f)(3) and add a sentence at the end.
5. Revise the last sentence of redesignated paragraph (f)(4)(ii).
6. Revise redesignated paragraph (f)(6).

The addition and revision to §1.401(k)–1 read as follows:

§1.401(k)–1 Certain cash or deferred arrangements.

* * * * *

(f) *Special rules for designated Roth contributions*.

(1) * * *

(ii) Treated by the employer as not excludible from the employee's gross income (in accordance with paragraph (f)(2) of this section);

(iii) Maintained by the plan in a separate account (in accordance with paragraph (f)(3) of this section).

(2) *Inclusion treatment*. An elective contribution is generally treated as not excludible from gross income if it is treated as includible in gross income by the employer (*e.g.*, by treating the contribution as wages subject to applicable income tax withholding). However, in the case of a self-employed individual, an elective contribution is treated as not excludible from gross income only if the individual does not claim a deduction for such amount. If an elective contribution would not have been includible in gross income if the amount had been paid directly to the employee (rather than being subject to a cash or deferral election), the elective contribution is nevertheless permitted to be a designated Roth contribution, provided the employee is entitled to treat the amount as an investment in the contract pursuant to section 72(f)(2).

(3) *Separate accounting required*. Under the separate accounting requirement of this paragraph (f)(3), contributions and withdrawals of designated Roth contributions must be credited and debited to a designated Roth account maintained for the employee and the plan must maintain a record of the employee's investment in the contract (that is, designated Roth contributions that have not been distributed) with respect to the employee's designated Roth account. * * * See A–13 of §1.402A–1 for additional requirements for separate accounting.

(4) * * *

(ii) * * * Moreover, a participant's designated Roth account and the participant's other accounts under a plan are treated as accounts held under two separate plans (within the meaning of section 414(l)) for purposes of applying the automatic rollover rules for mandatory distributions under section 401(a)(31)(B)(i)(I) and the special rules in A–9 through A–11 of §1.401(a)(31)–1.

* * * * *

(6) *Effective date*. Section 402A and the provisions of this section 1.401(k)–1(f) apply to taxable years beginning after December 31, 2005.

Par. 4. Section 1.402(g)–1 is amended as follows:

1. Revise the second sentence and add a third sentence to paragraph (a).
2. Add new paragraphs (b)(5) and (b)(6).
3. Revise paragraph (d).
4. Revise paragraph (e)(2) introductory text.
5. Revise paragraph (e)(2)(i).
6. Revise the second sentence and add a new third sentence in paragraph (e)(3)(i)(A).
7. Revise paragraph (e)(5)(i).
8. Add a sentence after the last sentence in paragraph (e)(5)(ii).
9. Revise paragraph (e)(5)(iii).
10. Add paragraph (e)(5)(v).
11. Add paragraph (e)(8)(iv).

The additions and revisions to §1.402(g)–1 read as follows:

§1.402(g)–1 Limitation on exclusion for elective deferrals.

(a) *In general*. * * * Thus, an individual's elective deferrals in excess of the applicable limit for a taxable year (that is, the individual's excess deferrals for the year) must be included in gross income for the year, except to the extent the excess deferrals are comprised of designated Roth contributions, and thus, are already includible in gross income. A designated Roth contribution is treated as an excess deferral only to the extent that the total amount of designated Roth contributions for an individual exceeds the applicable limit for the taxable year or the designated Roth contributions are identified as excess deferrals and the individual receives a distribution of the excess deferrals and allocable income under paragraph (e)(2) or (e)(3) of this section.

(b) * * *

(5) Any designated Roth contributions described in section 402A (before applying the limits of section 402(g) or this section).

(6) Any elective employer contributions to a SIMPLE retirement account, on behalf of an employee pursuant to a qualified salary reduction arrangement as described in section 408(p)(2) (before applying the limits of section 402(g) or this section).

* * * * *

(d) *Applicable limit*—(1) *In general*. Except as provided under paragraph (d)(2) of this section, the applicable limit for an individual's taxable year is the applicable dollar amount set forth in section 402(g)(1)(B). This applicable dollar amount is increased for the taxable year beginning in 2007 and later years in the same manner as the dollar amount under section 415(b)(1)(A) is adjusted pursuant to section 415(d). See §1.402(g)–2 for the treatment of catch-up contributions described in section 414(v).

(2) *Special adjustment for elective deferrals with respect to section 403(b) annuity contracts for certain long-term employees*. The applicable limit for an individual who is a qualified employee (as defined in section 402(g)(7)(C)) and has elective deferrals described in paragraph (b)(3) or (5) of this section for a taxable year is adjusted by increasing the applicable limit otherwise determined under paragraph (d)(1) of this section in accordance with section 402(g)(7).

(e) * * *

(2) *Correction of excess deferrals after the taxable year*. A plan may provide that if any amount is an excess deferral under paragraph (a) of this section:

(i) Not later than the first April 15 (or such earlier date specified in the plan) following the close of the individual's taxable year, the individual may notify each plan under which elective deferrals were made of the amount of the excess deferrals received by the plan. If any designated Roth contributions were made to a plan, the notification must also identify the extent, if any, to which the excess deferrals are comprised of designated Roth contributions. A plan may provide that an individual is deemed to have notified the plan of excess deferrals (including the portion of excess deferrals that are comprised of designated Roth contributions) to the extent the individual has excess deferrals for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer and the plan may provide the extent to which such excess deferrals are comprised of designated Roth contributions. A plan may instead provide that the employer may notify the plan on behalf of the individual under these circumstances.

* * * * *

(3) * * *

(i) * * *

(A) * * * If any designated Roth contributions were made to a plan, the notification must identify the extent to which, if any, the excess deferrals are comprised of designated Roth contributions. A plan may provide that an individual is deemed to have notified the plan of excess deferrals (including the portion of excess deferrals that are comprised of designated Roth contributions) for the taxable year calculated by taking into account only elective deferrals under the plan and other plans of the same employer and the plan may provide the extent to which such excess deferrals are comprised of designated Roth contributions. * * *

* * * * *

(5) *Income allocable to excess deferrals*—(i) *General rule*. The income allocable to excess deferrals for a taxable year that begins on or after January 1, 2007 is equal to the sum of the allocable gain or loss for the taxable year of the individual and, to the extent the excess deferrals are or will be credited with gain or loss for the period after the close of the taxable year and prior to the distribution (the gap period) if the total account were to be distributed, the allocable gain or loss during that period. The income allocable to excess deferrals for a taxable year that begins before 2007 is determined using the 1.402(g)–1(e)(5) (as it appeared in the April 1, 2006 edition of 26 CFR Part 1).

(ii) *Method of allocating income*. * * * A plan will not fail to use a reasonable method for computing the income allocable to excess deferrals merely because the income allocable to excess deferrals is determined on a date that is no more than 7 days before the distribution.

(iii) *Alternative method of allocating taxable year income*. A plan may determine the income allocable to excess deferrals for the taxable year by multiplying the income for the taxable year allocable to elective deferrals by a fraction. The numerator of the fraction is the excess deferrals by the employee for the taxable year. The denominator of the fraction is equal to the sum of:

(A) The total account balance of the employee attributable to elective deferrals as of the beginning of the taxable year, plus

(B) The employee's elective deferrals for the taxable year.

* * * * *

(v) *Alternative method for allocating taxable year and gap period income*. A plan may determine the allocable gain or loss for the aggregate of the taxable year and the gap period by applying the alternative method provided by paragraph (e)(5)(iii) of this section to this aggregate period. This is accomplished by substituting the income for the taxable year and the gap period for the income for the taxable year and by substituting the elective deferrals for the taxable year and the gap period for the elective deferrals for the taxable year in determining the fraction that is multiplied by that income.

* * * * *

(8) * * *

(iv) *Distributions of excess deferrals from a designated Roth account*. The rules of paragraph (e)(8)(iii) of this section generally apply to distributions of excess deferrals that are designated Roth contributions and the attributable income. Thus, if a designated Roth account described in section 402A includes any excess deferrals, any distribution of amounts attributable to those excess deferrals are includible in gross income (without adjustment for any return of investment in the contract under section 72(e)(8)). In addition, such distributions cannot be qualified distributions described in section 402A(d)(2) and are not eligible rollover distributions within the meaning of section 402(c)(4). For this purpose, if a designated Roth account includes any excess deferrals, any distributions from the account are treated as attributable to those excess deferrals until the total amount distributed from the designated Roth account equals the total of such deferrals and attributable income.

* * * * *

Par. 5. Sections 1.402A–1 and 1.402A–2 are added to read as follows:

§1.402A–1 Designated Roth Accounts

Q–1. What is a designated Roth account?

A–1. A designated Roth account is a separate account under a qualified cash or deferred arrangement under a section 401(a) plan, or under a section 403(b) plan, to which designated Roth contributions are permitted to be made in lieu of elective contributions, that satisfies the requirements of §1.401(k)–1(f) (in the case of a section 401(a) plan).

Q–2. How is a distribution from a designated Roth account taxed?

A–2. (a) The taxation of a distribution from a designated Roth account depends on whether or not the distribution is a qualified distribution. A qualified distribution from a designated Roth account is not includible in the distributee's gross income.

(b) Except as otherwise provided in paragraph (c) of this A–2, a qualified distribution is a distribution that is both—

(1) Made after the 5-taxable-year period of participation defined in A–4 of this section has been completed; and

(2) Made on or after the date the employee attains age 59$^{1}/_{2}$, made to a beneficiary or the estate of the employee on or after the employee's death, or attributable to the employee's being disabled within the meaning of section 72(m)(7).

(c) A distribution from a designated Roth account is not a qualified distribution to the extent it consists of a distribution of excess deferrals and attributable income described in §1.402(g)–1(e). See A–11 of this section for other amounts that are not treated as qualified distributions, including excess contributions described in section 401(k)(8), and excess aggregate contributions described in section 401(m)(8), and income, on any of these excess amounts.

Q–3. How is a distribution from a designated Roth account taxed if it is not a qualified distribution?

A–3. Except as provided in A–11 of this section, a distribution from a designated Roth account that is not a qualified distribution is taxable to the distributee under section 402 in the case of a plan qualified under section 401(a) and under section 403(b)(1) in the case of a section 403(b) plan. For this purpose, a designated Roth account is treated as a separate contract under section 72. Thus, except as otherwise provided in A–5 of this section for a rollover, if a distribution is before the annuity starting date, the portion of any distribution that is includible in gross income as an amount allocable to income on the contract and the portion not includible in gross income as an amount allocable to investment in the contract is determined under section 72(e)(8), treating the designated Roth account as a separate contract. Similarly, in the case of any amount received as an annuity, if a distribution is on or after the annuity starting date, the portion of any annuity payment that is includible in gross income as an amount allocable to income on the contract and the portion not includible in gross income as an amount allocable to investment in the contract is determined under section 72(b) or (d), as applicable, treating the designated Roth account as a separate contract. For purposes of section 72, designated Roth contributions are described in section 72(f)(1) or 72(f)(2), to the extent applicable.

Q–4. What is the 5-taxable-year period of participation described in A–2 of this section?

A–4. (a) The 5-taxable-year period of participation described in A–2 of this section for a plan is the period of 5 consecutive taxable years that begins with the first day of the first taxable year in which the employee makes a designated Roth contribution to any designated Roth account established for the employee under the same plan and ends when 5 consecutive taxable years have been completed. For this purpose, the first taxable year in which an employee makes a designated Roth contribution is the year in which the amount is includible in the employee's gross income. Notwithstanding the preceding, however, a contribution that is returned as an excess deferral or excess contribution does not begin the 5-taxable-year period of participation. Similarly, a contribution returned as a permissible withdrawal under section 414(w) does not begin the 5-taxable-year period of participation.

(b) Generally, an employee's 5-taxable-year period of participation is determined separately for each plan (within the meaning of section 414(l)) in which the employee participates. Thus, if an employee has elective deferrals made to designated Roth accounts under two or more plans, the employee may have two or more different 5-taxable-year periods of participation, depending on when the employee first had contributions made to a designated Roth account under each plan. However, if a direct rollover contribution of a distribution from a designated Roth account under another plan is made by the employee to the plan, the 5-taxable-year period of participation begins on the first day of the employee's taxable year in which the employee first had designated Roth contributions made to such other designated Roth account, if earlier than the first taxable year in which a designated Roth contribution is made to the plan. See A–5(c) of this section for additional rules on determining the start of the 5-taxable-year of participation in the case of an indirect rollover.

(c) The beginning of the 5-taxable-year period of participation is not redetermined for any portion of an employee's designated Roth account. This is true even if the entire designated Roth account is distributed during the 5-taxable-year period of participation and the employee subsequently makes additional designated Roth contributions under the plan.

(d) The rule in paragraph (c) of this section applies if the employee dies or the account is divided pursuant to a qualified domestic relations order (QDRO), and thus, a portion of the account is not payable to the employee and is payable to the employee's beneficiary or an alternate payee. In the case of distribution to an alternate payee or beneficiary, generally, the age, death, or disability of the employee is used to determine whether the distribution to an alternate payee or beneficiary is qualified. However, if an alternate payee or a spousal beneficiary rolls the distribution into a designated Roth account in a plan maintained by his or her own employer, such individual's age, disability, or death is used to determine whether a distribution from the recipient plan is qualified. In addition, if the rollover is a direct rollover contribution to the alternate payee's or spousal beneficiary's own designated Roth account, the 5-taxable-year period of participation under the recipient plan begins on the earlier of the date the employee's 5-taxable-year period of participation began under the distributing plan or the date the 5-taxable-year period of participation applicable to the alternate payee's or spousal beneficiary's designated Roth account began under the recipient plan.

(e) If a designated Roth contribution is made by a reemployed veteran for a year of qualified military service pursuant to section 414(u) that is before the year in which the contribution is actually made, the contribution is treated as having been made in the year of qualified military service to which the contribution relates, as designated by the reemployed veteran. Reemployed veterans may identify the year of qualified military service for which a contribution is made for other purposes, such as for entitlement to a match, and the treatment for the 5-taxable-year period of participation rule follows that identification. In the absence of such designation, for purposes of determining the first year of the five years of participation under section 402A(d)(2)(B), the contribution is treated as relating to the first year of qualified military service for which the reemployed veteran could have made designated Roth contributions under the plan, or if later the first taxable year in which designated Roth contributions could be made under the plan.

Q–5. How do the taxation rules apply to a distribution from a designated Roth account that is rolled over?

A–5. (a) An eligible rollover distribution from a designated Roth account is permitted to be rolled over into another designated Roth account or a Roth IRA, and the amount rolled over is not currently includable in gross income. In accordance with section 402(c)(2), to the extent that a portion of a distribution from a designated Roth account is not includible in income (determined without regard to the rollover), if that portion of the distribution is to be rolled over into a designated Roth account, the rollover must be accomplished through a direct rollover (*i.e.*, a 60 day rollover to another designated Roth account is not available for this portion of the distribution). For this purpose, any amount paid in a direct rollover is treated as a separate distribution from any amount paid directly to the employee. If a distribution from a designated Roth account is instead made to the employee, the employee would still be able to roll over the entire amount (or any portion thereof) into a Roth IRA within the 60-day period described in section 402(c)(3).

(b) In the case of an eligible rollover distribution from a designated Roth account that is not a qualified distribution and not paid as a direct rollover contribution, if less than the entire amount of the distribution is rolled over, the part that is rolled over is deemed to consist first of the portion of the distribution that is attributable to income under section 72(e)(8).

(c) If an employee receives a distribution from a designated Roth account, the portion of the distribution that would be includible in gross income is permitted to be rolled over into a designated Roth account under another plan. In such a case, §1.402A–2, A–3, provides for additional reporting by the recipient plan. In addition, the employee's period of participation under the distributing plan is not carried over to the recipient plan for purposes of satisfying the 5-taxable-year period of participation requirement under the recipient plan. Generally, the taxable year in which the recipient plan accepts such rollover contribution is the taxable year that begins the participant's new 5-taxable-year period of participation. However, if the participant is rolling over to a plan in which the participant already has a pre-existing designated Roth account with a longer period of participation, the starting date of the recipient account is used to measure the participant's 5-taxable-year period of participation.

(d) The following example illustrates the application of this A–5:

Example. Employee B receives a $14,000 eligible rollover distribution that is not a qualified distribution from B's designated Roth account, consisting of $11,000 of investment in the contract and $3,000 of income. Within 60 days of receipt, Employee B rolls over $7,000 of the distribution into a Roth IRA. The $7,000 is deemed to consist of $3,000 of income and $4,000 of investment in the contract. Because the only portion of the distribution that could be includible in gross income (the income) is rolled over, none of the distribution is includible in Employee B's gross income.

(e) This A–5 applies for taxable years beginning on or after January 1, 2006.

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.

(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.

Q–7. After a qualified distribution from a designated Roth account has been made, how is the remaining investment in the contract of the designated Roth account determined under section 72?

A–7. (a) The portion of any qualified distribution that is treated as a recovery of investment in the contract is determined in the same manner as if the distribution were not a qualified distribution. (See A–3 of this section.) Thus, the remaining investment in the contract in a designated Roth account after a qualified distribution is determined in the same manner after a qualified distribution as it would be determined if the distribution were not a qualified distribution.

(b) The following example illustrates the application of this A–7:

Example. Employee C receives a $12,000 distribution, which is a qualified distribution that is attributable to the employee being disabled within the meaning of section 72(m)(7), from C's designated Roth account. Immediately prior to the distribution, the account consisted of $21,850 of investment in the contract (*i.e.*, designated Roth contributions) and $1,150 of income. For purposes of determining recovery of investment in the contract under section 72, the distribution is deemed to consist of $11,400 of investment in the contract [$12,000 x 21,850/(1,150 + 21,850)], and $600 of income [$12,000 x 1,150/(1,150 + 21,850)]. Immediately after the distribution, C's designated Roth account consists of $10,450 of investment in the contract and $550 of income. This determination of the remaining investment in the contract will be needed if C subsequently is no longer disabled and takes a nonqualified distribution from the designated Roth account.

Q–8. What is the relationship between the accounting for designated Roth contributions as investment in the contract for purposes of section 72 and their treatment as elective deferrals available for a hardship distribution under section 401(k)(2)(B)?

A–8. (a) There is no relationship between the accounting for designated Roth contributions as investment in the contract for purposes of section 72 and their treatment as elective deferrals available for a hardship distribution under section 401(k)(2)(B). A plan that makes a hardship distribution under section 401(k)(2)(B) from elective deferrals that includes designated Roth contributions must separately determine the amount of elective deferrals available for hardship and the amount of investment in the contract attributable to designated Roth contributions for purposes of section 72. Thus, the entire amount of a hardship distribution is treated as reducing the otherwise maximum distributable amount for purposes of applying the rule in section 401(k)(2)(B) and §1.401(k)–1(d)(3)(ii) that generally limits hardship distributions to the principal amount of elective deferrals made less the amount of elective deferrals previously distributed from the plan, even if a portion of the distribution is treated as income under section 72(e)(8).

(b) The following example illustrates the application of this A–8:

Example. The facts are the same as in the *Example* in A–7 of this section, except that instead of being disabled, Employee C is receiving a hardship distribution. In addition, Employee C has made elective deferrals that are not designated Roth contributions totaling $20,000 and has received no previous distributions of elective deferrals from the plan. The adjustment to the investment in the contract is the same as in A–7 of this section, but for purposes of determining the amount of elective deferrals available for future hardship distribution, the entire amount of the distribution is subtracted from the maximum distributable amount. Thus, Employee C has only $29,850 ($41,850 - $12,000) available for hardship distribution from C's designated Roth account.

Q–9. Can an employee have more than one separate contract for designated Roth contributions under a plan qualified under section 401(a) or a section 403(b) plan?

A–9. (a) Except as otherwise provided in paragraph (b) of this A–9, for purposes of section 72, there is only one separate contract for an employee with respect to the designated Roth contributions under a plan. Thus, if a plan maintains one separate account for designated Roth contributions made under the plan and another separate account for rollover contributions received from a designated Roth account under another plan (so that the rollover account is not required to be subject to the distribution restrictions otherwise applicable to the account consisting of designated Roth contributions made under the plan), both separate accounts are considered to be one contract for purposes of applying section 72 to the distributions from either account.

(b) If a separate account with respect to an employee's accrued benefit consisting of designated Roth contributions is established and maintained for an alternate payee pursuant to a qualified domestic relations order and another designated Roth account is maintained for the employee, each account is treated as a separate contract for purposes of section 72. The alternate payee's designated Roth account is also a separate contract for purposes of section 72 with respect to any other account maintained for that alternate payee. Similarly, if separate accounts are established and maintained for different beneficiaries after the death of an employee, the separate account for each beneficiary is treated as a separate contract under section 72 and is also a separate contract with respect to any other account maintained for that beneficiary under the plan that is not a designated Roth account. When the separate account is established for an alternate payee or for a beneficiary (after an employee's death), each separate account must receive a proportionate amount attributable to investment in the contract.

Q–10. What is the tax treatment of employer securities distributed from a designated Roth account?

A–10. (a) If a distribution of employer securities from a designated Roth account is not a qualified distribution, section 402(e)(4)(B) applies. Thus, in the case of a lump-sum distribution that includes employer securities, unless the taxpayer elects otherwise, net unrealized appreciation attributable to the employer securities is not includible in gross income; and such net unrealized appreciation is not included in the basis of the distributed securities and is capital gain to the extent such appreciation is realized in a subsequent taxable transaction.

(b) In the case of a qualified distribution of employer securities from a designated Roth account, the distributee's basis in the distributed securities for purposes of subsequent disposition is their fair market value at the time of distribution.

Q–11. Can an amount described in A–4 of §1.402(c)–2 with respect to a designated Roth account be a qualified distribution?

A–11. No. An amount described in A–4 of §1.402(c)–2 with respect to a designated Roth account cannot be a qualified distribution. Such an amount is taxable under the rules of §§1.72–16(b), 1.72(p)–1, A–11 through A–13, 1.402(g)–1(e)(8), 1.401(k)–2(b)(2)(vi), 1.401(m)–2(b)(2)(vi), or 1.404(k)–1T. Thus, for example, loans that are treated as deemed distributions pursuant to section 72(p), or dividends paid on employer securities as described in section 404(k) are not qualified distributions even if the deemed distributions occur or the dividends are paid after the employee attains age 59½ and the 5-taxable-year period of participation defined in A–4 of this section has been satisfied. However, if a dividend is reinvested in accordance with section 404(k)(2)(A)(iii)(II), the amount of such a dividend is not precluded from being a qualified distribution if later distributed. Further, an amount is not precluded from being a qualified distribution merely because it is described in section 402(c)(4) as an amount not eligible for rollover. Thus, a hardship distribution is not precluded from being a qualified distribution.

Q–12. If any amount from a designated Roth account is included in a loan to an employee, do the plan aggregation rules of section 72(p)(2)(D) apply for purposes of determining the total amount an employee is permitted to borrow from the plan, even though the designated Roth account generally is treated as a separate contract under section 72?

A–12. Yes. If any amount from a designated Roth account is included in a loan to an employee, notwithstanding the general rule that the designated Roth account is treated as a separate contract under section 72, the plan aggregation rules of section 72(p)(2)(D) apply for purposes of determining the maximum amount the employee is permitted to borrow from the plan and such amount is based on the total of the designated Roth contribution amounts and the other amounts under the plan. To the extent a loan is from a designated Roth account, the repayment requirement of section 72(p)(2)(C) must be satisfied separately with respect to that