CONNER & WINTERS

ATTORNEYS & COUNSELORS AT LAW

Conner & Winters, LLP
Suite 900
1627 I Street, N.W.
Washington, D.C. 20006
202-887-5711
Fax 202-887-6999
www.cwlaw.com

Writer's E-mail Address
dmiller@cwlaw.com

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VIA ELECTRONIC FILING

CC:PA:LPD:PR (REG-146459-05)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Proposed Regulations on Designated Roth Accounts under Section 402A

Dear Sir or Madam:

We represent a number of clients who maintain church retirement plans, both qualified Code section 401(a) plans and Code section 403(b)(9) church retirement income accounts. These plans pose some unique issues with respect to the administration of designated Roth accounts. In this connection, we are writing to provide comments on the regulations proposed to be promulgated under sections 402(g), 402A, and 403(b) of the Internal Revenue Code of 1986, as amended ("Code"), which were published in the Federal Register on January 26, 2006 (the "Proposed Regulations").

Foreign Missionaries

We request clarification as to whether foreign missionaries are permitted to make designated Roth contributions to their denomination's 403(b)(9) plan. Compensation paid to a foreign missionary is generally excluded from his/her gross income under Code section 911. The Code specifically provides that section 911 income is included in the definition of "includible compensation," thus enabling foreign missionaries to make contributions to their denominational 403(b) plans within the normal Code section 415(c) limits. *See* Code

§ 403(b)(3). However, because the compensation paid to foreign missionaries is nontaxable income, it is unclear whether they can make designated Roth contributions to their denominational plans.

The applicable guidance in the final 401(k) regulations includes several requirements for designated Roth contributions that impact whether a foreign missionary can make designated Roth contributions. First, the regulations provide that a designated Roth contribution must be "an elective contribution under a cash or deferred arrangement [that is designated] irrevocably by the employee . . . as a designated Roth contribution that is being made in lieu of all or a portion of the pre-tax elective contributions the employee is otherwise eligible to make under the plan." Second, the designated Roth contribution must be "treated by the employer as includible in the employee's gross income at the time the employee would have received the amount in cash if the employee had not made the cash or deferred election." Treas. Reg. § 1.401(k)-1(f)(1). (emphasis added)

Both of these requirements seem to require that the employee have otherwise taxable compensation in order to make an election between pre-tax contributions and Roth contributions. As discussed above, a foreign missionary does not generally have taxable compensation and thus has no opportunity to elect to make contributions on a pre-tax basis.

In addition to the language in Treasury Regulation section 1.401(k)-1(f)(1), other provisions in the 401(k) regulations suggest that a designated Roth contribution is available only to employees with taxable compensation. As noted, the regulations provide that a designated Roth contribution is an "elective contribution." Under Treasury Regulation section 1.401(k)-5, the term "elective contributions" is defined as "employer contributions made to a plan pursuant to a cash or deferred election under a cash or deferred arrangement." A "cash or deferred election" is defined in Treasury Regulation section 1.401(k)-1(a)(3) as an election by the employee to have the employer either "(A) Provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available; or (B) Contribute an amount to a trust . . . under a plan deferring the receipt of compensation." (emphasis added)

Thus, foreign missionaries can make elective contributions to their denomination plan under Code section 415. We would like clarification that these foreign missionaries can designate these elective contributions as Roth contributions.

Self-Employed Ministers

A self-employed minister is permitted to participate in his or her denominational section 403(b)(9) church plans and the minister's includible compensation is determined by reference to his or her earned income from self-employment, to the extent such income was earned for services in the exercise of ministry. Code § 414(e)(5)(B). Further, contributions made by such self-employed ministers to a section 403(b)(9) plan are deductible to the extent that such contributions do not exceed either the annual contributions limit under Code section 415(c) or the limit on elective deferrals under Code section 402(g). Code § 404(a)(10).

Because the Code specifically allows self-employed ministers to make contributions within the applicable elective deferral limits, we believe that self-employed ministers are permitted to treat contributions they make to their denomination's 403(b)(9) plan as elective deferrals, as long as those contributions do not exceed the limits of Code section 402(g). We therefore believe that self-employed ministers should also be able to elect to treat all or a portion of these elective deferrals as designated Roth contributions, to the extent that the plan permits such a designation, as long as these ministers pay taxes on the amounts that are contributed to the plan on a Roth basis.

The Proposed Regulations do not specifically address the issue of whether self-employed ministers can make designated Roth contributions. Because the law is unclear on this issue, we respectfully request that the IRS provide clarification that self-employed ministers are entitled to make designated Roth contributions to a 403(b)(9) plan from their net earnings from self-employment, as long as those contributions do not exceed the Code section 402(g) limits on elective deferrals.

Calculation of Five-Year Participation Period

The Proposed Regulations provide that the five-year participation period "begins on the first day of the first taxable year in which the participant makes a contribution to a designated Roth account established for the employee under the same plan and ends when 5 consecutive taxable years have been completed." Proposed Regulations § 1.402A-2, Q & A 4(a). An employee's 5-year period of participation is determined separately for each plan (within the meaning of section 414(l)) in which the employee participates. Proposed Regulations § 1.402A-2, Q & A 4(b).

The regulations under Code section 414(l) define a "single plan" as one in which "all of the plan assets are available to pay benefits to employees who are covered by the plan and their beneficiaries." The regulations further provide:

> However, more than one plan will exist if a portion of the plan assets is not available to pay some of the benefits. This will be so even if each plan has the same benefit structure or plan document, or if all or part of the assets are invested in one trust with separate accounting with respect to each plan.

Treas. Reg. § 1.414(l)-1(b)(1).

The definition of "single plan" in Code section 414(l) does not appear to cover most denominational church plans, either qualified 401(a) plans or 403(b)(9) retirement income accounts. Such plans typically are multiple employer plans and the plan assets are not available to pay the benefits to employees of all the different employers participating in these plans. Rather, the assets for the employees of each employer are separately accounted for. However, all of these separate plans are administered by the denominational board under one multiple

employer plan document so that employees who move from one church employer to another within the same denomination can continue to participate in the denominational plan.

We note that Code section 415(c)(7) provides that all years of service as an employee of a church or church-related organization is considered as years of service for one employer. Although this statutory provision is technically only applicable with respect to Code section 415(c)(7), the IRS has informally indicated that it also applies with respect to the special Code section 402(g) catch-up contribution limit available to employees with 15 or more years of service with the same employer. *See* Code 402(g)(7). We believe that a similar aggregation concept should apply in the context of designated Roth contributions so that employees who participate in their denominational plans are considered to be working for one employer and participating in one plan.[1]

Under these circumstances, we believe that the participation period should be calculated beginning on the first day in which the employee makes a designated Roth contribution to the plan of any participating employer covered under the denominational plan, no matter how many different participating employers the participant works for. With respect to this conclusion, we note that Code section 415(c)(7) provides that all years of service as an employee of a church or church-related organization is considered as years of service for one employer. Although this statutory provision is technically only applicable with respect to Code section 415(c)(7), the IRS has informally indicated that it also applies with respect to the special Code section 402(g) catch-up contribution limit available to employees with 15 or more years of service with the same employer. *See* Code 402(g)(7). We believe that a similar aggregation concept should apply in the context of designated Roth contributions so that employees who participate in their denominational plans are considered to be working for one employer and participating in one plan.

The Proposed Regulations could be interpreted to mean that the five-year participation period is calculated separately for each employer that participates in the denominational plan, which could create significant administrative burdens for these multiple employer church plans, particularly with respect to tracking designated Roth contributions in the case of plan loans, hardship distributions and the like. Therefore, we respectfully request that the final regulations clarify that participants in a denominational church plan have only one five-year participation period, regardless of how many participating employers they have worked for.

A second issue related to the five-year participation period is how to calculate this period in the case of an employee who makes contributions to his or her denominational church plan

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[1] The issue would not arise if the controlled group rules were applicable to churches and qualified church controlled organizations ("QCCOs"). Although the law is unclear with respect to how the controlled group rules apply to churches and QCCOs, if the proposed regulations under Code section 414(c) become final, the controlled group rules will be inapplicable to churches and QCCOs. *See* Proposed Regulations § 1.414(c)-5(a).

and also makes salary reduction contributions to a 403(b) plan offered by a different vendor. Sometimes an individual employer will participate in the denominational 403(b)(9) plan and also make available a separate 403(b) plan utilizing a different vendor, to allow participants more flexibility. In this situation, since the assets of the denominational 403(b)(9) plan are not available to pay benefits under the other vendor's plan (and vice versa), the denominational 403(b)(9) plan and the other vendor's plan are separate plans within the meaning of Code section 414(l). Therefore, we would like the IRS to clarify that a denominational church plan need only track the five-year participation period with respect to designated Roth contributions made to the plans that it administers or maintains.

Separate Accounting Requirements

In general, all payments from a Code section 403(b) plan are taxed in accordance with the rules of Code section 72 so that the investment in the contract is generally allocated to each withdrawal from the entire Code section 403(b) plan on a pro rata basis. However, Code section 72(d)(2) allows plans to consist of two parts for purposes of Code section 72: a separate 72(d)(2) contract for employee contributions (and earnings thereon) and a contract for the remaining portion of the plan (such as employer contributions, employer matching contributions, and any employee contributions that have not been accounted for separately and thus are not included in the separate 72(d)(2) contract).

Section 1.402A-1, Q & A 3 of the Proposed Regulations provides that "a designated Roth account is treated as a separate contract under section 72." We would appreciate confirmation that it is now possible for a 401(a) or 403(b) plan to have three separate contracts – one for Roth contributions (and earnings thereon), a second for non-Roth after-tax contributions (and earnings thereon), and a third for all other contributions in the plan (and earnings thereon) – and that the taxation under Code section 72 is determined separately for each such contract. We further would like confirmation that a plan is permitted to specify the order in which distributions are made from the plan, so distributions could first be made from the Roth account, then from the after-tax account and then from the account holding the remaining contributions.

Nondiscrimination Testing

Because designated Roth contributions are treated as elective deferrals, we assume that these contributions can be recharacterized under Treasury Regulation section 1.401(k)-2(b)(3) for purposes of passing the ADP test. However, neither the final regulations under Code section 401(k) nor the Proposed Regulations explicitly state that such recharacterization is permissible. We would therefore confirmation that designated Roth contributions can be recharacterized for purposes of passing the ADP test.

Assuming that recharacterization of Roth contributions is permissible, we would also appreciate guidance on the mechanics of making the recharacterization. We believe that the recharacterization should work as follows:

> If the $1,000 account balance of designated Roth contributions consists of $500 of earnings and $500 contributions and the plan needs to recharacterize $200 (which includes applicable earnings on the correction) to pass the ADP test, the plan would recharacterize $100 in contributions and $100 in earnings, report the earnings as taxable, decrease the basis in the designated Roth account by $50, and consider the recharacterized dollars (including earnings) as after-tax (but treat them like elective deferrals as provided in Treasury Regulation section 1.401(k)-2(b)(3)(iii)(C)). In other words, these recharacterized Roth contributions are no longer designated Roth contributions.

Although we believe that the recharacterization is accomplished in the manner described above, it would be helpful to have some specific guidance on the mechanics of recharacterization.

In addition, the final 401(m) regulations provide that corrective distributions can be made from designated Roth contributions. Treasury Regulation § 1.401(m)-2(b)(vi)(C). We were not sure if this provision was intended to allow 403(b) plans to make corrective distributions of Roth contributions under Code section 401(m), and, if so, how such a corrective distribution would be accomplished.

Treasury Regulation section 1.401(m)-2(b)(vi)(C) provides for corrective distributions of excess aggregate contributions. The term "excess aggregate contributions" is defined as the amount of excess aggregate contributions apportioned to a highly compensated employee under section 1.401(m)-2(b)(2)(iii), which is calculated based on each highly compensated employee's actual contribution ratio ("ACR"). Treas. Reg. §§ 1.401(m)-5 and 1.401(m)-2(b)(ii). The "ACR" is the sum of employee and matching contributions, along with qualified nonelective <u>and elective contributions</u> taken into account under Treasury Regulation section 1.401(m)-2(a)(6). Treas. Reg. § 1.401(m)-2(a)(3). Elective contributions taken into account under the Code section 401(m) ACP test do not include "elective deferrals made pursuant to a salary reduction agreement under an annuity described in section 403(b)." Treasury Regulation § 1.401(m)-2(a)(6). We assume that because 403(b) elective deferrals are subject to the universal availability nondiscrimination rule rather than the ADP testing applicable to 401(k) elective deferrals, it is specifically intended that the provisions of Treasury Regulation section 1.401(m)-2(b)(vi)(C) have no application with respect to a section 403(b) plan and would appreciate clarification to that effect.

<u>Definition of Designated Roth Contributions</u>

Treasury Regulation section 1.401(k)-1(f)(1)(ii) provides that a designated Roth contribution must be "treated by the employer as includible in the employee's gross income <u>at the time the employee would have received the amount in cash</u> . . . ." (emphasis added) We believe that this provision could be interpreted as requiring income inclusion on a paycheck-by-paycheck basis so that if, through administrative error or otherwise, even one paycheck fails to include the designated Roth amount in taxable income, such amount would not be treated as a

designated Roth contribution, even though the year-end Form W-2 would identify the total amount of taxable Roth contributions. We would like confirmation that such a year-end adjustment on the participant's Form W-2 will satisfy the requirement that the designated Roth contribution must be treated by the employer as includible in income at the time the employee would have received the amount in cash.

Direct Rollovers of Designated Roth Accounts

The Proposed Regulations provide that a direct rollover from a designated Roth account in a section 401(a) qualified plan "may only be made to another plan qualified under section 401(a) . . . (i.e., it cannot be rolled over into a section 403(b) plan)." Proposed Regulation § 1.402A-1, Q & A 5. However, the model amendments that were issued on April 23, 2006, appear to permit rollovers to any plan described in Code section 402A(e)(1), which includes both section 401(a) qualified plans and section 403(b) plan. Specifically, the model amendments include the following suggested language:

> Notwithstanding section ______, a direct rollover of a distribution from a Roth elective deferral account under the plan will only be made to another Roth elective deferral account under an applicable retirement plan described in §402A(e)(1) or to a Roth IRA described in §408A, and only to the extent the rollover is permitted under the rules of § 402(c).

Restricting rollovers of Roth accounts between section 401(a) plans and section 403(b) plans is contrary to the congressional intent in enacting the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which is the legislation that authorized the establishment of designated Roth accounts. EGTRRA was intended to promote portability among plans. Therefore, we believe that the Proposed Regulations should be revised to conform to the model amendments and to permit direct rollovers of designated Roth accounts from section 401(a) plans to section 403(b) plans, and from section 403(b) plans to section 401(a) plans.

Direct Transfers Between 403(b) Plans (90-24 Transfers)

Code section 403(b) plans are permitted to make direct plan-to-plan transfers pursuant to Revenue Ruling 90-24. The proposed regulations under Code section 403(b) incorporate the provisions of Revenue Ruling 90-24 (with some modifications) so that a plan-to-plan transfer from one section 403(b) plan to another section 403(b) plan is permitted if certain conditions are met. Proposed Regulation § 1.403(b)-10(b)(3). We would like clarification as to whether such plan to plan transfers can include designated Roth contributions and, if so, what the responsibilities are for both the transferring plan and the recipient plan with respect to recordkeeping and reporting. We assume that the plans would be subject to similar rules as are applicable in the case of rollovers, so that the transferring plan will be required to provide a statement as to the first year of the five-year participation period and the portion of the distribution attributable to basis, and the five-year period of participation in the receiving plan will begin on the first day of the employee's taxable year for which the employee first made

designated contributions to the transferring plan (if such date is earlier). However, it would be helpful to have confirmation to that effect.

We appreciate the opportunity to comment on the proposed Roth 401(k)/403(b) rules. If additional information from us would be helpful, please call either of us at 202-887-5711.

Respectfully submitted,

Danny Miller

Erica L. Summers