Plan Distributions

Pension Portability Enhanced by EGTRRA's New Rollover Rules

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EGTRRA significantly increases pension portability and encourages plan participants and IRA owners to keep retirement savings in tax-favored retirement arrangements. This column explains how.

Effective for distributions made after December 31, 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) changes the rules that govern rollovers of retirement plan and individual retirement arrangement (IRA) distributions in the following ways.

INCREASED PORTABILITY FOR PARTICIPANTS

Pre-EGTRRA Rules

Under the law as in effect prior to EGTRRA, the rollover rules permitted the rollover of funds from a tax-favored retirement plan to another tax-favored retirement plan. The rules that applied prior to EGTRRA depended on the type of plan involved. Similarly, the rules regarding the tax treatment of amounts that were not rolled over depended on the type of plan involved. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Distributions from Qualified Plans

Under pre-EGTRRA law, an "eligible rollover distribution" from a tax-qualified Internal Revenue Code (Code) Section 401(a) employer-sponsored retirement plan could be rolled over, tax free, to a traditional IRA or another Code Section 401(a) qualified plan. (The term *traditional* IRA refers to an IRA other than a Roth IRA or a SIMPLE IRA.) An eligible rollover distribution was any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except that it did not include (1) any distribution that was one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary or (b) for a specified period of 10 or more years, (2) any distribution to the extent such distribution was required under Code Section 401(a)(9)'s minimum distribution rules, or (3) certain hardship distributions. The maximum amount that could be rolled over was the amount of the distribution includible in income; that is, after-tax employee contributions could not be rolled over. Qualified plans were not required to accept rollovers. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Distributions from Tax-Sheltered Annuities

Eligible rollover distributions from a tax-sheltered Code Section 403(b) annuity could be rolled over into a traditional IRA or another Code Section 403(b) annuity. Distributions from a Code Section 403(b) annuity could not be rolled over into a Code Section 401(a) qualified plan. Code Section 403(b) annuities were not required to accept rollovers. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Traditional IRA Distributions

Distributions from a traditional IRA, other than minimum required distributions, could be rolled over into another traditional IRA. In general, distributions from a traditional IRA could not be rolled over into a Code Section 401(a) qualified plan or Code Section 403(b) annuity. An exception to this rule applied in

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the case of so-called conduit IRAs. Under the conduit IRA rule, amounts could be rolled over from a Code Section 401(a) qualified plan into a traditional IRA and subsequently rolled back into another Code Section 401(a) qualified plan if the amounts in the traditional IRA were attributable solely to rollovers from a Code Section 401(a) qualified plan. Similarly, an amount could be rolled over from a Code Section 403(b) annuity to a traditional IRA and subsequently rolled back into a Code Section 403(b) annuity if the amounts in the traditional IRA were attributable solely to rollovers from a Code Section 403(b) annuity. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Distributions from Code Section 457 Plans

Distributions from a Code Section 457 plan could not be rolled over into another Code Section 457 plan, a Code Section 401(a) qualified plan, a Code Section 403(b) annuity, or a traditional IRA. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Rollovers by Surviving Spouses

A surviving spouse who received an eligible rollover distribution could roll over the distribution into a traditional IRA, but not into a Code Section 401(a) qualified plan or a Code Section 403(b) annuity. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Changes Made by EGTRRA

In General

EGTRRA significantly increased pension portability, effective for distributions made after December 31, 2001. In general, EGTRRA provides that eligible rollover distributions from Code Section 401(a) qualified retirement plans, Code Section 403(b) annuities, and governmental Code Section 457 plans may be rolled over to *any* such plan or arrangement. (Eligible rollover distributions do not, however, include hardship distributions from governmental Code Section 457 plans.) Similarly, distributions from a traditional IRA are generally permitted to be rolled over into a Code Section 401(a) qualified plan, a Code Section 403(b) annuity, or a governmental Code Section 457 plan. The pre-EGTRRA direct rollover and withholding rules have been extended to distributions from a governmental Code Section 457 plan, and such plans are required to provide the written notification (the "rollover notice") regarding eligible rollover distributions. The rollover notice (with respect to all plans) is required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different from those applicable to distributions from the distributing plan. As under pre-EGTRRA law, Code Section 401(a) qualified plans, Code Section 403(b) annuities, and Code Section 457 plans would not be required to accept rollovers. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Some special rules apply in certain cases. A distribution from a Code Section 401(a) qualified plan is not eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under pre-EGTRRA law. Thus, to preserve capital gains and averaging treatment for a Code Section 401(a) plan distribution that is rolled over, the rollover would have to be made to a conduit IRA, as under pre-EGTRRA law, and then rolled back into a Code Section 401(a) qualified plan. Amounts distributed from a Code Section 457 plan are subject to the 10 percent early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Code Section 457 plans are required to account separately for such amounts. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Rollover of After-Tax Contributions

EGTRRA provides that employee after-tax contributions may be rolled over into another Code Section 401(a) qualified plan or a traditional IRA. In the case of a rollover from a Code Section 401(a) qualified plan to another

Code Section 401(a) qualified plan, the rollover is permitted to be accomplished only through a direct rollover. In addition, a Code Section 401(a) qualified plan is not permitted to accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon). After-tax contributions (including nondeductible contributions to an IRA) are not permitted to be rolled over from an IRA into a Code Section 401(a) qualified plan, a Code Section 403(b) tax-sheltered annuity, or a Code Section 457 plan. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

In the case of a distribution into an eligible rollover plan that is not an IRA, the distribution is attributed first to amounts other than after-tax contributions. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Expansion of Spousal Rollovers

EGTRRA provides that surviving spouses may roll over distributions to a Code Section 401(a) qualified plan, Code Section 403(b) annuity, or Code Section 457 plan in which the surviving spouse participates. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Treasury Regulations

In EGTRRA, Congress directed the Secretary of the Treasury to prescribe rules necessary to carry out EGTRRA's provisions. Such rules may include, for example, reporting requirements and mechanisms to address mistakes relating to rollovers. It is anticipated that the IRS will develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could, for example, expand Form 8606, Nondeductible IRAs, to include information regarding after-tax contributions. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

EGTRRA's Effective Date

EGTRRA's new rollover rules are effective for distributions made after December 31, 2001. Congress intends that the Secretary of the Treasury will revise the safe harbor rollover notice that plans may use to satisfy the rollover requirements. No penalty will be imposed on a plan for a failure to provide the information required under EGTRRA with respect to any distribution made before the date that is 90 days after the date the IRS issues a new safe harbor rollover notice if the plan administrator makes a reasonable attempt to comply with such notice requirement. For example, EGTRRA requires that the rollover notice include a description of the provisions under which distributions from the eligible retirement plan receiving the distribution may be subject to restrictions and tax consequences that are different from those applicable to distributions from the plan making the distribution. A plan will be treated as making a reasonable good-faith effort to comply with this requirement if the notice states that distributions from the plan to which the rollover is made may be subject to different restrictions and tax consequences than those that apply to distributions from the plan from which the rollover is made. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

WAIVER OF 60-DAY RULE

Pre-EGTRRA Rules

Under pre-EGTRRA law, amounts received from an IRA or Code Section 401(a) qualified plan could be rolled over, tax free, if the rollover was made within 60 days of the date of the distribution. Under pre-EGTRRA law, the Secretary of the Treasury did not have the authority to waive the 60-day requirement, except during military service in a combat zone or by reason of a Presidentially declared disaster. The IRS has issued regulations postponing the 60-day rule in such cases. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Changes Made by EGTRRA

EGTRRA provides that the Secretary of the Treasury may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. For example, the Secretary of the Treasury may issue guidance that includes objective standards for a waiver of the 60-day rollover period, such as waiving the rule because of military service in a combat zone or during a Presidentially declared disaster (both of which are provided for under pre-EGTRRA law), or for a period during which the participant has received payment in the form of a check but has not cashed the check, or for errors committed by a financial institution, or in cases of inability to complete a rollover due to death, disability, hospitalization, incarceration, restriction imposed by a foreign country, or postal error. These new rules apply to distributions made after December 31, 2001. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

EMPLOYERS MAY DISREGARD ROLLOVERS FOR PURPOSES OF CASH-OUT RULES

Pre-EGTRRA Rules

Under pre-EGTRRA law, if a Code Section 401(a) qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute his or her vested accrued benefit without his or her consent, and if applicable, without the consent of his or her spouse, if the present value of the benefit does not exceed $5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit. A similar provision is contained in Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Generally, a participant could roll over an involuntary distribution from a Code Section 401(a) qualified plan to an IRA or to another Code Section 401(a) qualified plan. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Changes Made by EGTRRA

Under EGTRRA, for purposes of the cash-out rule, a plan may provide that the present value of a participant's vested accrued benefit is determined without regard to the portion of such benefit that is attributable to rollover contributions (and any earnings allocable thereto). The new rules are effective for distributions made after December 31, 2001. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

AUTOMATIC ROLLOVERS OF CERTAIN MANDATORY DISTRIBUTIONS

Pre-EGTRRA Rules

Under pre-EGTRRA law, if a Code Section 401(a) qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's vested accrued benefit without the participant's consent, and if applicable, without the consent of his or her spouse, if the present value of the benefit does not exceed $5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit. Generally, a participant could roll over an involuntary distribution from a Code Section 401(a) qualified plan. Before making a distribution that was eligible for rollover, a plan administrator had to provide the participant with a written explanation of the ability to have the distribution rolled over directly to an IRA or another Code Section 401(a) qualified plan and of the related tax consequences. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

Changes Made by EGTRRA

EGTRRA makes a direct rollover the default option for involuntary distributions that exceed $1,000 and that are eligible rollover distributions from Code Section 401(a) qualified retirement plans. The distributions must be rolled over automatically to a designated IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or a Code Section 401(a) qualified plan or to receive it directly.

The written explanation provided by the plan administrator is required to explain that an automatic direct rollover will be made unless the participant elects otherwise. The plan administrator is also required to notify the participant in writing (as part of the general written explanation or separately) that the distribution may be transferred without cost to another IRA.

EGTRRA also amends the fiduciary rules of ERISA so that in the case of an automatic direct rollover, the participant is treated as exercising control over the assets in the IRA upon the earlier of (1) the rollover of any portion of the assets to another IRA, or (2) one year after the automatic rollover.

In EGTRRA, Congress directed the Secretary of Labor to issue safe harbors under which the designation of an institution and the investment of funds in accordance with the new rules are deemed to satisfy the requirements of ERISA Section 404(a).

In addition, EGTRRA authorizes the Secretary of the Treasury and the Secretary of Labor to consider providing special relief with respect to the use of low-cost individual retirement plans for purposes of the new rules and for other uses that promote the preservation of tax-qualified retirement assets for retirement income purposes. EGTRRA directs the Secretary of Labor to adopt final regulations implementing these new rules not later than three years after June 7, 2001 (the date of EGTRRA's enactment). The new rules apply to distributions that occur after the Department of Labor has adopted final regulations implementing EGTRRA. [Joint Committee on Taxation Summary of Provisions Contained In the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001 (JCX-50-01), May 26, 2001]

CONCLUSION

EGTRAA's new rollover rules significantly increase pension portability and encourage plan participants and IRA owners to keep their retirement savings in tax-favored retirement arrangements until they need to draw on those savings to sustain them during their retirement years. The new rollover rules can potentially give retirees sole control, including investment control, over the funds that they have accumulated during their working years.