

**COMMENTS OF THE COMMITTEE OF ANNUITY INSURERS
ON PROPOSED REGULATIONS UNDER IRC SECTION 402A**

[REG-146459-05]

[71 Fed. Reg. 4320 (January 26, 2006)]

April 26, 2006

The Committee of Annuity Insurers (the “Committee”) appreciates this opportunity to provide the Department of the Treasury and the Internal Revenue Service (the “Service”) with comments on the proposed regulations under section 402A regarding the treatment of distributions from designated Roth accounts (the “Proposed Regulations”).¹ The Committee is a coalition of life insurance companies that was formed in 1982 to participate in the development of federal tax policy with respect to annuities. The Committee’s current 29 members, a list of which is attached, represent most of the nation’s largest and most prominent issuers of annuities and are among the largest issuers of section 403(b) annuity contracts. Accordingly, the Committee’s comments on the Proposed Regulations focus on certain issues that are relevant to the use of annuity products in connection with designated Roth accounts. These issues are discussed below. The Committee also would appreciate the opportunity to discuss these issues at a public hearing on the Proposed Regulations.

I. Final regulations should clarify and provide examples of the treatment of distributions from annuity contracts that include provisions affecting both the Roth and non-Roth accounts

A. In general

Section 402A(b)(2) provides that a qualified Roth contribution program must (1) establish separate accounts for the designated Roth contributions of each employee and any earnings properly allocable to the contributions and (2) maintain separate recordkeeping with respect to each account. It seems apparent from this provision and the Proposed Regulations that the separate accounting and recordkeeping requirements may be satisfied using separate accounting entries under a single annuity contract, *e.g.*, a single section 403(b) annuity may accept both Roth and non-Roth contributions. This single contract approach might be used, for example, in order to take advantage of certain economies of scale or to otherwise reduce costs to consumers, or because the benefits have been priced in a manner that requires a single contract be used. In this regard, some member companies of the Committee have been issuing annuity contracts with both Roth and non-Roth accounts, or adding Roth accounts to existing annuity contracts, since section 402A became effective on January 1, 2006.

¹ The Proposed Regulations also amend the regulations under sections 402(g), 403(b), and 408A. Unless otherwise indicated, all references to sections are to sections of the Internal Revenue Code of 1986, as amended (the “Code”).

As described in our comment letter on this regulation project dated October 6, 2005, variable annuity contracts often include guarantees that protect the owner against financial risks that could adversely affect their preparedness for retirement. These types of benefits fall within two general categories, which are referred to colloquially in the life insurance industry as “living” benefits and “death” benefits. For example, some contracts offer one or more of the following types of living benefits at the election of the owner:

- *Guaranteed minimum income benefits* providing the owner the ability to annuitize the contract at a certain age and be guaranteed annuity payments at a minimum level regardless of the contract’s actual account value on the annuitization date;
- *Guaranteed minimum accumulation benefits* providing the owner with a guaranteed minimum account value at certain pre-determined times; and
- *Guaranteed minimum withdrawal benefits* providing the owner with the right to withdraw a certain percentage of his or her contributions (or an amount determined by reference to contributions) for a specified duration, *e.g.*, the annuitant’s life or until the contributions are recovered, irrespective of the contract’s actual account value on the date of the withdrawal.

In addition, some annuity contracts offer one or more of the following types of death benefits at the election of the owner:

- *Return of premium (“ROP”) death benefits* providing the beneficiary with a guaranteed payment equal to the greater of (1) the premiums paid less an adjustment for withdrawals (*i.e.*, the “net” premiums) and (2) the account value as of the date of death;
- *Periodic step-up or “ratchet” death benefits* providing the beneficiary with a guaranteed payment equal to the greater of (1) the ROP death benefit and (2) the highest account value on a prior specified date (*e.g.*, each contract anniversary date);
- *Guaranteed return or “rollup” death benefits* providing the beneficiary with a guaranteed payment equal to the greater of (1) the account value and (2) the net premiums paid plus interest at a specified rate; and
- *Percentage of gain death benefits* providing the beneficiary with a guaranteed payment equal to the account value plus a specified percentage of any “gain” in the contract on the date of death.

The foregoing types of annuity benefits are illustrative of the types of product designs available in the marketplace today. In addition, it can be expected that future innovations in product design will improve upon these features and that new benefit designs will be introduced. The Committee believes that final regulations should provide guidance with respect to the treatment of these types of benefits that is broad enough to address not only current product designs but that also can be adapted to address future innovations.

In this regard, the foregoing types of annuity benefits share certain common characteristics and purposes. Generally, the benefit amount is affected by the entire policy value, so that in the case of a variable annuity with the policy value attributable in part to a Roth account and in part to a non-Roth account, both can affect the amount of the single contractual benefit paid. Each of these types of benefits provides the contract owner with protection against certain financial risks that, absent the benefit, might discourage the owner from investing some or all of his account balance in equity markets. In this regard, while equity investments typically involve greater volatility than fixed income investments such as government bonds, they historically have produced a greater return than fixed income investments. By helping to reduce or eliminate the risk that a downturn in the equity markets will leave the contract owner without adequate retirement savings or will leave his or her spouse, family, or other beneficiaries without adequate financial support in the event of an untimely death, these types of annuity benefits encourage equity investments and better financial preparedness for retirement. Therefore, the Committee believes that final regulations should not discourage the use of these important annuity contract features.

In order to avoid potential ambiguities that might discourage the use of these contract benefits, final regulations should clarify how the separate accounting requirement applies to them. In particular, potential ambiguities could arise due to the fact that each of the foregoing types of annuity benefits (and, presumably, similar future innovations in annuity product designs) can result in cash distributions that exceed the account value available for withdrawal in a lump-sum at the time of the benefit payment. In the case of an annuity contract that includes both a designated Roth account and a non-Roth account, this raises the question of how to properly characterize a distribution as being allocable to the Roth account or the non-Roth account.

For example, an annuity contract might include both types of accounts and provide an ROP death benefit that covers the contract in its entirety, such that the benefit is measured by comparing the sum of all premiums paid into the Roth account and the non-Roth account against the sum of the Roth and non-Roth account values, rather than being measured as if a separate ROP death benefit was provided for each account. This issue is illustrated in the following simple example –

Example. Assume that an individual owns a section 403(b) annuity contract that provides an ROP death benefit. A designated Roth account and a non-Roth account are maintained under the contract. The owner makes after-tax contributions of \$100 to the designated Roth account and allocates the contributions to an investment option that enjoys favorable investment performance such that the value of the designated Roth account increases to \$125. The owner also makes pre-tax contributions of \$100 to the non-Roth account and allocates the contributions to an investment option that experiences poor investment performance such that the value of the non-Roth account drops to \$50. The owner then dies when the total account value under the contract equals \$175 (\$125 from the designated Roth account and \$50 from the non-Roth

account). As a result of the ROP feature, upon the owner's death the beneficiary receives a lump sum payment of \$200 because the premiums paid (\$100 to the designated Roth account plus \$100 to the non-Roth account) exceeds the total account value (\$125 in the designated Roth account plus \$50 in the non-Roth account).

Thus, in the foregoing example, the balances of the Roth and non-Roth accounts will be distributed in full, plus an additional \$25. The issuing life insurance company and the contract beneficiary will need to determine which portion of that \$25 will be treated as a distribution from the designated Roth account and which portion will be treated as a distribution from the non-Roth account. To enable annuity issuers and owners to make such tax characterizations, the Committee believes that final regulations should provide a general rule coupled with specific examples of separate accounting methods that can be used in conjunction with the general rule. This approach was used in the final regulations under section 401(a)(9) governing required minimum distributions from annuity contracts with additional benefits, and has worked well.²

B. General rule

With regard to the general rule referenced above, the Committee respectfully requests that final regulations provide that –

If an annuity contract under which a designated Roth account and a non-Roth account are maintained provides for a benefit that is determined by reference to the combined value of the Roth and non-Roth accounts, any reasonable accounting method that is consistent with the terms and operation of the contract and that accurately reflects the economics of the arrangement may be used to determine the extent to which a distribution made pursuant to such a benefit is a distribution from the designated Roth account or the non-Roth account. However, the same reasonable accounting method must be used to make such determinations with respect to all distributions that are made as a result of a particular benefit under the same annuity contract, must be identified by the issuer at the earliest date that Roth contributions are made to the arrangement (or the date that the benefit is first available under the contract, if later), and may not be changed except with the permission of the Secretary.

Such a general rule would provide annuity issuers with the flexibility they need to address a variety of different types of annuity contract benefits that exist in the marketplace today as well as provide a rule that could be applied to later innovations in annuity product design. Moreover, such a general rule would operate to prevent potential abuses by clearly stating a standard of

² See Treas. Reg. section 1.401(a)(9)-6, Q&A-12(b).

reasonableness and allowing the use of only those accounting methods that are grounded in economic reality. In addition, this general rule would be further buttressed by the provision already included in the Proposed Regulations under which –

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.³

When combined with the general rule that the Committee has proposed above, annuity issuers (and, thus, annuity owners) would be required to use a reasonable accounting method that is grounded in the economics of the arrangement and that does not have the effect of transferring value from one account to another. Further, the rule that the Committee has proposed above would specifically require annuity issuers to be consistent in their use of a particular accounting method in connection with a particular contract, although issuers would be allowed to use different accounting methods with respect to different types of benefits under the same contract.⁴ In addition, the rule would require issuers to choose the applicable method at the time the first Roth contribution is made. These requirements will preclude “method shopping” at the time distributions are made. Moreover, these requirements could be coupled with a recordkeeping requirement under which the issuing life insurance company must maintain records showing the methodology that is used with respect to a particular type of benefit under a particular annuity contract. Taken together, these consistency and reporting requirements would provide needed flexibility in a manner that is consistent with the separate accounting requirement and would provide the Service with the information it needs to confirm compliance.

C. Illustrative examples

As indicated above, the Committee also respectfully requests that final regulations include examples illustrating the application of the foregoing general rule. Because different types of annuity contract benefits may require different accounting methods to comply with the general rule stated above, the examples included in final regulations should be illustrative rather than exhaustive. In other words, the final regulations should clearly indicate that, depending on the facts and circumstances, methodologies other than those illustrated in the examples provided

³ Prop. Treas. Reg. section 1.402A-1, Q&A-13.

⁴ For example, “Methodology A” might be appropriate for “Benefit Type A” but “Methodology B” might be more appropriate for “Benefit Type B.” In such case, the consistency requirement would be satisfied as long as Methodology A was used to determine the tax character of all distributions attributable to Benefit Type A and Methodology B was used to determine the tax character of all distributions attributable to Benefit Type B. Such a situation might arise, for example, due to limitations that the issuing life insurance company faces under the computerized systems it uses to administer the contracts it issues.

in the regulations can comply with the general rule expressed above, and that the examples provided in the final regulations constitute permissible, but not the exclusive, means of complying with that rule.

In this regard, the Committee has identified at least four different methods that might be appropriate to determine the tax character of these types of distributions depending on the specific facts and circumstances. These methods are described below.

1. *The relative account balance method*

Under this method, the tax character of distributions would be determined by reference to the relative account balances held in the designated Roth account and the non-Roth account as of the date the benefit is paid or determined. To illustrate this approach, consider the following two examples:

Example 1: ROP Death Benefit---Assume the same facts as the ROP example discussed on page 3 above, *i.e.*, the owner contributes \$100 to the Roth account and \$100 to the non-Roth account then dies when the Roth account balance is \$125 and the non-Roth account balance is \$50. Under these facts, the \$200 death benefit would be characterized as follows:

- \$50 would be treated as a distribution of the account balance maintained under the non-Roth account;
- \$125 would be treated as a distribution of the account balance maintained under the designated Roth account; and
- The remaining \$25 paid pursuant to the ROP benefit would be treated in part as a distribution from the non-Roth account and in part as a distribution from the designated Roth account, as follows:
 - \$7.15 would be treated as a distribution from the non-Roth account, determined by dividing the account balance of that account (\$50) by the total account balance of the annuity contract (\$175) and multiplying the result (28.6%) by the amount of the additional benefit payment (\$25);
 - \$17.85 would be treated as a distribution from the designated Roth account, determined by dividing the account balance of that account (\$125) by the total account balance of the annuity contract (\$175) and multiplying the result (71.4%) by the amount of the additional benefit payment (\$25).

Example 2: Guaranteed Minimum Income Benefit---Assume that an annuity contract includes a guaranteed minimum income benefit, which, as described on page 2 above, provides the owner with the right to annuitize the contract at a certain age and be guaranteed annuity payments at a minimum level regardless of the contract's actual account value on the

annuitization date. Assume further that on Date X the owner applies the entire contract value to an annuity option that makes fixed monthly payments for the longer of the owner's life or 10 years. On that date, the non-Roth account has a balance of \$100,000, which based on the annuity option provides monthly payments of \$675. The Roth account has a balance of \$75,000, which based on the annuity option provides monthly payments of \$500. Thus, the owner will receive a combined monthly payment of \$1,175. However, as a result of the guaranteed minimum income benefit, the combined monthly payment is increased to \$1,500. Under the relative account balance method, these annuity payments would be characterized as follows:

- \$675 would be treated as a distribution from the non-Roth account;
- \$500 would be treated as a distribution from the designated Roth account; and
- The remaining \$325 paid pursuant to the guaranteed minimum income benefit would be treated in part as a distribution from the non-Roth account and in part as a distribution from the designated Roth account, as follows:
 - \$185.71 would be treated as a distribution from the non-Roth account, determined by dividing the account balance of that account as of the date annuity payments are determined (\$100,000) by the total account balance of the annuity contract on that date (\$175,000) and multiplying the result (57.14%) by the amount of the additional benefit payment (\$325);
 - \$139.29 would be treated as a distribution from the designated Roth account, determined by dividing the account balance of that account as of the date annuity payments are determined (\$75,000) by the total account balance of the annuity contract on that date (\$175,000) and multiplying the result (42.86%) by the amount of the additional benefit payment (\$325).

In accordance with the general rule discussed on pages 4 through 5 above, the relative account balance method would be available only if the charges that the issuer imposes for the benefit are assessed against both the non-Roth account and the Roth account in a manner that accurately reflects the economics of the arrangement. Thus, for example, if the charge for the benefit in the examples above were assessed entirely against the non-Roth account, the relative account balance method would not be available. In this regard, it would be inappropriate to characterize a benefit as having a Roth character where that benefit was funded entirely through a non-Roth account. In contrast, however, there are a number of charging structures that would generally accurately reflect the economics of a benefit. Thus, for example, if a charge of 10 basis points on all accounts is imposed to fund the benefit, then the relative account method would be available. Similarly, if a charge of 10 basis points is calculated as a percentage of a

referenced value and assessed against both the non-Roth account and the Roth account, then this method should be available.⁵ By way of another example, if a fixed charge of \$10 is imposed to fund the benefit, that \$10 charge would need to be assessed ratably against the account balances of the non-Roth and Roth accounts in order for this method to be available.⁶

2. *The relative net contribution (contributions adjusted for withdrawals) method*

Under this method, the tax character of distributions would be determined solely by reference to the allocations of net premiums (*i.e.*, premiums adjusted for withdrawals) between the Roth and non-Roth accounts. To illustrate this approach, consider the following two examples:

Example 1: ROP Death Benefit---Assume the same facts as the ROP example discussed on page 3 above, *i.e.*, the owner contributes \$100 to the Roth account and \$100 to the non-Roth account then dies when the Roth account balance is \$125 and the non-Roth account balance is \$50. Under these facts, the \$200 death benefit would be characterized as follows:

- \$50 would be treated as a distribution of the account balance maintained under the non-Roth account;
- \$125 would be treated as a distribution of the account balance maintained under the designated Roth account; and
- Half of the remaining \$25 paid pursuant to the ROP benefit would be treated as a distribution from the non-Roth account and half would be treated as a distribution from the Roth account because premiums were split evenly between those accounts.

Example 2: Guaranteed Return or “Rollup” Death Benefit---Assume that an individual owns a section 403(b) annuity contract that provides a guaranteed return or “rollup” death benefit, which, as described on page 2 above, provides the beneficiary with a guaranteed payment equal to the

⁵ For example, charges might be calculated as a percentage (stated in basis points) of a “benefit base,” which is a term commonly used to identify the notional value representing the amount available for withdrawal or distribution as a result of the benefit, such as the net premiums plus interest at a stated rate in the case of a guaranteed return or “rollup” death benefit. In such cases, the basis point charge would need to be assessed against the Roth account and the non-Roth account according to their relative benefit bases (if separately calculated) in order for the relative account balance method to be available.

⁶ For example, if the \$10 charge is assessed at a time when the Roth account balance is \$4,000 and the non-Roth account balance is \$6,000, then \$4 would need to be assessed against the Roth account and \$6 would need to be assessed against the non-Roth account.

greater of (1) the account value and (2) the net premiums paid plus interest at a specified rate. Assume further that the owner makes net contributions (*i.e.*, contributions adjusted for withdrawals) of \$100 to the Roth account and \$300 to the non-Roth account, then dies at a time when the Roth account balance is \$125 and the non-Roth account balance is \$325. At the time of her death, by virtue of the guaranteed return death benefit the contract pays a total death benefit of \$500. Under these facts, the \$500 death benefit payment would be characterized as follows:

- \$125 would be treated as a distribution of the account balance maintained under the designated Roth account;
- \$325 would be treated as a distribution of the account balance maintained under the non-Roth account; and
- The remaining \$50 paid pursuant to the guaranteed return death benefit would be treated in part as a distribution from the designated Roth account and in part as a distribution from the non-Roth account, as follows:
 - \$12.50 would be treated as a distribution from the designated Roth account, determined by dividing the net contributions to that account (\$100) by the total net contributions to the contract (\$400) and multiplying the result (25%) by the amount of the additional benefit payment (\$50);
 - \$37.50 would be treated as a distribution from the non-Roth account, determined by dividing the net contributions to that account (\$300) by the total net contributions to the contract (\$400) and multiplying the result (75%) by the amount of the additional benefit payment (\$50).

As with the reasonable account balance method discussed above, and for the same reasons expressed on page 7 above, the availability of the relative net contribution method would be conditioned on the charge structure for the benefit accurately capturing the economics of the benefit.

3. *The net amount at risk method*

Under the NAR method, the tax character of distributions would be determined by reference to the “net amount at risk” or “NAR” under each account as it relates to the additional benefit being provided. To illustrate this approach, consider the following two examples:

Example 1: ROP Death Benefit with Increasing and Declining Account Balances--- Assume the same facts as the ROP example discussed on page 3 above, *i.e.*, the owner contributes \$100 to the Roth account and \$100 to the non-Roth account then dies when the Roth account balance is \$125

and the non-Roth account balance is \$50. Under these facts, the \$200 death benefit would be characterized as follows:

- \$50 would be treated as a distribution of the account balance maintained under the non-Roth account;
- \$125 would be treated as a distribution of the account balance maintained under the designated Roth account; and
- The remaining \$25 paid pursuant to the ROP benefit would be treated as a distribution from the non-Roth account because the non-Roth account generated the NAR that triggered the payment of the ROP benefit. In other words, because the account balance of the designated Roth account (\$125) exceeds the premiums paid for that account (\$100), it has no NAR, whereas because the account balance of the non-Roth account (\$50) is less than the premiums paid for that account (\$100), it creates the NAR that triggers the ROP benefit.

Example 2: ROP Death Benefit with Declining Account Balances---

Assume the same facts as above except that on the date of death the non-Roth account balance was \$25 and the Roth account balance was \$60. As a result, the non-Roth account presents an NAR of \$75 (the \$100 premiums paid minus the \$25 account balance) and the Roth account presents an NAR of \$40 (the \$100 premiums paid minus the \$60 account balance), for a total NAR of \$115. In such case, under the NAR method the \$200 ROP death benefit would be characterized as follows:

- \$25 would be treated as a distribution of the account balance maintained under the non-Roth account;
- \$60 would be treated as a distribution of the account balance maintained under the designated Roth account; and
- The remaining \$115 paid pursuant to the ROP benefit would be treated in part as a distribution from the non-Roth account and in part as a distribution from the designated Roth account, as follows:
 - \$75 would be treated as a distribution from the non-Roth account, and
 - \$40 would be treated as a distribution from the designated Roth account.

As with the reasonable account balance method discussed above, and for the same reasons expressed on page 7 above, the availability of the NAR method would be conditioned on the charge structure accurately capturing the economics of the arrangement.

4. *The charges method*

Under this method, the tax character of distributions would be determined solely by reference to the account against which charges for the benefit were assessed. In other words, annuity issuers would look to the dollar amount of the charges actually imposed against each account and allocate the tax character of the benefit payment in accordance with the relative levels of those charges. Unlike the relative account balance and NAR methods described above, this method could be used irrespective of the charge structure for a particular benefit. To illustrate this approach, consider the following two examples:

Example 1: ROP Death Benefit---Assume the same facts as the ROP example discussed on page 3 above, *i.e.*, the owner contributes \$100 to the Roth account and \$100 to the non-Roth account then dies when the Roth account balance is \$125 and the non-Roth account balance is \$50. If the charges for the ROP benefit were assessed entirely against the designated Roth account, then the \$200 death benefit paid to the beneficiary would be characterized as follows:

- \$50 would be treated as a distribution of the account balance maintained under the non-Roth account;
- \$125 would be treated as a distribution of the account balance maintained under the designated Roth account; and
- The remaining \$25 paid pursuant to the ROP benefit also would be treated as a distribution from the designated Roth account because the ROP benefit was funded entirely through charges assessed against the designated Roth account.

Example 2: Guaranteed Minimum Withdrawal Benefit---Assume that an annuity contract provides a guaranteed minimum withdrawal benefit, which, as described on page 2 above, allows the owner to withdraw annually for the rest of her life a certain percentage of her contributions irrespective of the actual account balance under the contract. Assume further that she takes guaranteed minimum withdrawals of \$500 per month until both the non-Roth account and the Roth account are exhausted on Date X. After Date X, while the non-Roth account and the Roth account have zero balances, she continues to receive \$500 per month until she recovers all of the premiums she paid for the contract.

- If the same charges were assessed against both the Roth and non-Roth accounts to fund the guaranteed minimum withdrawal benefit (*e.g.*, because both accounts had the same account balances and the charge was a percentage of those balances), then \$250 of each \$500 monthly payment made after Date X would be treated as a distribution from the non-Roth account and \$250 would be treated as a distribution from the Roth account.

- Similarly, if charges for the guaranteed minimum withdrawal benefit were assessed entirely against one account or the other, then each \$500 payment after Date X would be treated as a distribution from the account against which the charges were assessed.

In effect, the charges method described above treats the contract right (in the examples above, the ROP benefit and the guaranteed minimum withdrawal benefit) as an investment option akin to any other investment option under a variable annuity contract or a mutual fund option in a trusteed plan. In that context, the separate accounting requirement is satisfied to the extent contributions are made to the investment option using Roth amounts. Here, the separate accounting requirement should be satisfied to the same extent.

One issue presented by the charges method is the appropriate look-back period for determining the source of the payments that purchase the contract right. In general, the Committee believes that the appropriate look-back period should be determined based on the terms of the contract right. For example, if a contract right has a one-year term or can be canceled by the owner without the imposition of future charges, *e.g.*, if charges give rise to coverage under the contract right for a one-year period that may or may not be renewed, then the appropriate look-back period would be one year. Similarly, some contract rights may have a term that is equal to the duration of the contract. In such a case, it might be more appropriate to take into account the cumulative charges imposed since the benefit became effective under the contract.

Accordingly, the Committee requests that final regulations clarify that the look-back period should be determined in a manner that is consistent with the contract provisions governing the relevant benefit. In addition, the Committee requests that the rule anticipate the fact that annuity issuers have not been required to track cumulative charges in the past for any purpose under the Code or regulations, and that as a result data with respect to such prior charges may be difficult or impossible to obtain. In such cases, the Committee suggests that it would be appropriate for final regulations to allow annuity issuers to use a reasonable approximation of the cumulative charges, or to base the determination of the cumulative charges on a limited number of prior contract years (*e.g.*, cumulative charges from the prior two contract years). This approach would be consistent with the approach previously taken by the Service in an analogous circumstance. In this regard, disability payments that are attributable to after-tax premium payments are excludible from gross income while disability payments that are attributable to pre-tax premium payments are includible in gross income.⁷ Treasury regulations generally provide for a “three-year look-back rule” in determining the source of the premium payments. However, the regulations expressly provide that “[i]f the net premiums for such coverage for a period of at least three policy years are not known at the beginning of the calendar year but are known for at least one policy year, such determination shall be made by using the net premiums for such coverage which are known at the beginning of the calendar year.”⁸

⁷ See Treas. Reg. section 1.105-1(d)(2); *see also* Revenue Ruling 2004-55, 2004-26 I.R.B. 1081.

⁸ See Treas. Reg. section 1.105-1.

D. Summary

As indicated above, the Committee believes that the appropriate method for allocating contract benefits between a designated Roth account and a non-Roth account will depend on the specific facts and circumstances, and that pursuant to the general rule summarized above a particular methodology might not be appropriate in all cases. However, by providing specific examples of appropriate accounting methods as the Committee has suggested, the regulations necessarily also would illustrate accounting methods that are inappropriate in certain contexts. Taken together, the general rule and the specific examples will prevent contract benefits from transferring, directly or indirectly, value from a non-Roth account to a Roth account, while illustrating methodologies that do not violate that prohibition.

In this regard, the requirement that the methodology accurately reflect the economics of the arrangement by itself substantially assures that any given methodology will be appropriate. For example, if charges for an ROP benefit were assessed entirely against the non-Roth account, then it would be inappropriate to characterize a distribution paid pursuant to the ROP benefit as being allocable to the Roth account. This characterization would be inconsistent with the underlying economics of the arrangement. That is, regardless of the manner in which the amount of the benefit is determined, any accounting method must be consistent with the manner in which the contract right is purchased. In contrast, however, where the contract right has been purchased through a charge that is assessed consistently against both accounts or where the charge is implicit in the contract itself,⁹ it may be appropriate (and easy for employees to understand) if the character of a distribution made pursuant to that contract right is determined using a methodology that reflects the manner in which the amount of the benefit is determined. For example, if an ROP benefit is determined solely by reference to the NAR with respect to the non-Roth account (and the charges are assessed consistently against both accounts), then it would be inappropriate to characterize a distribution paid pursuant to the ROP benefit as being fully allocable to the Roth account.

In addition, under each of the examples discussed above, the tax character of a distribution will be dictated by market forces that can equally affect both the Roth and non-Roth account. The effect of those market forces will be unknown when the methodology is chosen at the time the first Roth contribution is made to the contract. Thus, in situations where both Roth and non-Roth monies are used to fund a particular benefit, the methodology necessarily will be neutral as to whether a later distribution made pursuant to that benefit will be characterized as a Roth or non-Roth distribution. This neutrality in outcome will comport with the economics of these arrangements (as required by the general rule discussed above) because, by virtue of the unknown effects of future market forces, their charge structures themselves are neutral as to such

⁹ One reason that the charges method should not be the exclusive method of determining the tax character of a contract right is that the charges for certain benefits are not explicitly identified. For example, it would be relatively unusual for an ROP benefit charge to be explicitly stated as a separate charge. Rather, the charge for an ROP benefit is ordinarily part of the mortality and expense charge that is applied against all of the accounts in a contract.

outcome.¹⁰ As a result, the Committee believes that these methods are reasonable and appropriate.

In short, by establishing the framework that the Committee has proposed, the Treasury Department and the Service would provide annuity owners and issuers with the guidance they need to properly make such determinations in a manner that is both workable and consistent with sound tax policy. Such guidance is critically important not only because the existence of Roth and non-Roth accounts under the same annuity contract is likely to increase in the future, but also because, as described above, some insurers have already begun issuing and administering such products, and those products often include the types of annuity benefits described above.

II. Final regulations should clarify the tax treatment of annuity payments from designated Roth accounts

A. Final regulations should clarify the calculation of taxable amounts under section 72(d)

Distributions from a section 403(b) annuity contract can be taken in several different forms, including periodic withdrawals or partial surrenders. Such payments typically are received before the “annuity starting date” and therefore are characterized as “amounts not received as an annuity.” Pursuant to sections 72(e)(2) and (8), such payments are included in gross income to the extent allocable to income on the contract and excluded from gross income to the extent allocable to the investment in the contract. The allocation of an amount received before the annuity starting date between the investment in the contract and the income on the contract is determined under section 72(e)(8).

Section 403(b) annuity contracts issued by a life insurance company also contain various annuity payout options, including, *e.g.*, a life annuity for the employee and a joint and last survivor annuity for the employee and a joint annuitant such as the employee’s spouse. These annuity payments typically are taxed under section 72(d) using what is sometimes referred to as the “simplified exclusion ratio.”¹¹ As a technical matter, annuity payments receive such treatment only if the payments are “amounts received as an annuity.”¹² Payments constitute

¹⁰ Likewise, in situations where a benefit is funded entirely through charges assessed against one account or another, the charges method described above will comport with the economics of the arrangement by ensuring that the payout will have the same tax character as the source of money used to purchase the benefit.

¹¹ In cases where the annuitant is over age 75 and there are 5 or more years of guaranteed payments under the annuity, annuity payments are still taxed under section 72(b). Section 72(d)(1)(E); Notice 98-2, 1998-1 C.B. 266.

¹² Section 72(d)(1).

“amounts received as an annuity” only if they are received after the “annuity starting date,” as defined in section 72(c)(4), and meet certain other requirements.¹³

The tax treatment under section 72(d) of “amounts received as an annuity” is conceptually similar to the rules applicable to amounts received before the annuity starting date under section 72(e)(8), in that under both provisions each payment is divided between an amount included in income and an amount excluded from income. However, the manner of determining the includible and excludible portions differs in material ways between the two.¹⁴ As a result, it is important that the regulations governing distributions from designated Roth accounts that are not “qualified distributions” (hereinafter, “non-qualified distributions”) clearly distinguish between the rules applicable to amounts taxed pursuant to the simplified exclusion ratio under section 72(d) and amounts taxed using the *pro rata* allocation rule under section 72(e)(8).

In this regard, Q&A-3 of the Prop. Treas. Reg. section 1.402A-1 describes the section 72(e)(8) rule applicable to distributions before the annuity starting date and then states, in relevant part, as follows:

Similarly, 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), treating the designated Roth account as a separate contract.

Although presumably the intent of this statement is simply to confirm the use of the simplified exclusion ratio of section 72(d) for payments constituting “amounts received as an annuity,” the omission of this term from the regulation, the reference to section 72(b) (rather than section 72(d)), and the use of the terms “allocable to income on the contract” and “allocable to investment in the contract,” which are used in the Code only in connection with payments made *before* the annuity starting date (see section 72(e)(2)(B)), has caused some confusion.¹⁵ To eliminate this confusion, the Committee suggests that this part of Q&A-3 be revised to read as follows (deletions are shown as stricken text and insertions shown as double-underlined text):

~~Similarly, if~~ If a distribution is made on or after the annuity starting date and is an amount received as an annuity, the portion

¹³ See generally Treas. Reg. section 1.72-2(b)(2).

¹⁴ Under section 72(e)(8), the excludible portion of a distribution is determined by multiplying the distribution by a fraction, the numerator of which is the investment in the contract and the denominator of which is the account balance. Under section 72(d), the excludible portion of each distribution is equal to the investment in the contract as of the annuity starting date divided by the number of payments anticipated to be made under the annuity.

¹⁵ We note that this issue does not arise in connection with Roth IRAs because distributions from Roth IRAs are governed by the ordering rules of section 408A(d)(4)(B).

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~~ that is excludible from 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.

B. Final regulations should clarify the tax treatment of annuity payments and qualified distributions

Section 402A(d)(1) provides that “[a]ny qualified distribution from a designated Roth account shall not be includible in gross income.” Consistently, Q&A-2(a) of Prop. Treas. Reg. section 1.402A-1 provides that the “taxation of a distribution from a designated Roth account depends on whether or not the distribution is a qualified distribution” and that a “qualified distribution from a designated Roth account is not includible in the distributee’s gross income.” Section 402A(d)(2)(A) defines a “qualified distribution” by reference to section 408A(d)(2)(A). Based on this definition, Q&A-2(b) explains that a “qualified distribution” (with certain exceptions) 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 ½, made to the beneficiary or 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).

Section 402A(d)(2)(B) emphasizes that both of these conditions must be satisfied for a payment or distribution to be a qualified distribution by providing that “[a] payment or distribution from a designated Roth account shall not be treated as a qualified distribution if such payment or distribution is made within the 5-taxable-year period” defined therein.

It is apparent from the foregoing that each payment or distribution from a designated Roth account must be measured against the two conditions set forth in Q&A-2(b) to determine whether it is an excludible qualified distribution. The fact that one payment or distribution is not a qualified distribution (*e.g.*, because the 5-year-taxable period has passed, but the employee is age 56) does not mean that the next payment or distribution made to the employee may not be a qualified distribution (*e.g.*, a payment made after the employee attains age 59 ½).¹⁶

¹⁶ This conclusion is consistent with Q&A-7 of Prop. Treas. Reg. section 1.402A-1, which makes it clear that a distribution made at one point in time may be a qualified distribution if the participant is disabled at that time, while a distribution made to the same participant at a later time may be a non-qualified distribution if the participant is no longer disabled at that time. (continued ...)

Consistently with this framework, it is possible that an employee could begin a series of payments or distributions at a time when the payments were not qualified distributions, but after an event occurs (death) or time passes (the employee reaches age 59 ½) the payments could become qualified distributions. For example, an employee could begin a series of substantially equal periodic payments in accordance with Rev. Rul. 2002-62, 2002-2 C.B. 710, or begin a series of lifetime annuity payments, prior to the 5-year-taxable period having expired, but that payments later would be made after the 5-year-taxable period had expired. The Committee believes that it would be helpful for taxpayers if the Treasury Department and the Service would clarify that in such circumstances the payments made after the 5-year-taxable period are qualified distributions. This clarification could be made by including the following example in Q&A-3:

Example. Employee B made his first contribution to the designated Roth account under his employer's 403(b) plan in his 2006 taxable year. On January 1, 2010, Employee B has reached age 65 and retires. On that date, Employee B's designated Roth account contains \$15,000 in designated Roth contributions which are treated as employer contributions described in section 72(f)(1) and the Roth account balance is \$20,000. On January 1, 2010, Employee B applies the \$20,000 to a life annuity option offered under his section 403(b) annuity contract. As a result, Employee B will begin receiving payments of \$135 on the first day of every month for as long as he lives. The monthly payments B will receive qualify as "amounts received as an annuity."

Employee B receives \$1,620 from his annuity in 2010 (12 x \$135). None of the monthly payments is a qualified distribution because, although B has reached age 59 ½, only four taxable years have been completed since he made his first designated Roth contribution to the plan and therefore the 5-taxable-year period has not expired at the time he receives the payments. Accordingly, the payments are taxed under section 72(d). Pursuant to those rules, \$692.31 is excludible from B's income in 2010 as a recovery of his investment in the contract. (\$15,000 divided by 260 (the number of anticipated payments to be received by B times 12).) As a result, \$927.69 of the annuity payments is includible in B's income in 2010.

Employee B receives another \$1,620 in monthly annuity payments in 2011. All of the payments are qualified distributions because

Thus, the status of a distribution as qualified or non-qualified is determined at the time of the actual distribution.

after December 31, 2010, the 5-taxable-year period has expired. None of the \$1,620 is includible in B's income in 2011.

C. Final regulations should clarify the tax treatment of distributed annuity contracts

The Committee believes that final regulations should address how section 402A applies to annuity contracts that include a Roth account and that are distributed from a section 401(k) or 403(b) plan. Specifically, the Committee respectfully submits that final regulations should provide that whether a payment from a distributed annuity contract is a qualified distribution is to be determined at the time of the payment (and not the distribution of the annuity contract). In this regard, the final regulations should provide that the 5-taxable-year period includes periods after the annuity contract has been distributed from the plan and that all other relevant determinations, including determining the participant's age, are made at the time of the payment. Similarly, the final regulations should confirm that investment gains and other appreciation on Roth accounts after the date the contract is distributed are excludible from gross income if paid as part of a qualified distribution.

By way of background, it is not uncommon for a qualified plan to provide that benefits are paid in cash or, at the election of a participant, in the form of an annuity contract. If a qualified plan provides for an annuity contract form of distribution, the plan would ordinarily issue an individual annuity contract in the name of the participant. Once the contract is issued in the name of the participant, the plan ceases to have any rights under the contract. There are also situations in which an individual annuity contract is "distributed" from a section 403(b) arrangement. In this regard, for example, the proposed section 403(b) regulations explicitly provide that individual annuity contracts may be distributed to plan participants in connection with termination of a section 403(b) arrangement.¹⁷

The tax law provides a number of specific rules governing the treatment of plan-distributed annuity contracts. Treasury regulations state that the distribution of an annuity contract is ordinarily not considered a taxable event, even if the contract has a cash surrender value.¹⁸ Instead, payments from the contract are taxed as made, even if those payments do not commence until many years after the contract was distributed from the plan. For purposes of the tax qualification, distributed annuity contracts are effectively treated as continuations of the tax-qualified plans from which they were paid. For example, payments from a distributed annuity contract are treated as eligible rollover distributions (if they otherwise would qualify as such), the spousal consent requirements apply to distributions from the contract, and the required minimum distribution rules continue to apply to distributed annuity contracts.¹⁹

¹⁷ See Prop. Treas. Reg. section 1.403(b)-10(a) ("A distribution includes delivery of a fully paid individual insurance annuity contract.").

¹⁸ See Treas. Reg. section 1.402(a)-1(a)(2).

¹⁹ See, e.g., Treas. Reg. section 1.401(a)(9)-6 (minimum required distributions); Treas. Reg. section 1.401(a)-20, Q&A-20 (spousal consent to distributions); Treas. Reg. section

(continued ...)

The Committee believes it would be appropriate to include in the final regulations a specific provision addressing distributed annuity contracts under section 402A. In this regard, the Committee believes that treating a distributed annuity contract as a continuation of the plan for purposes of section 402A would be entirely consistent with the tax treatment of distributed annuity contracts generally. Moreover, any other answer would create anomalous results. Although somewhat uncommon, qualified plans may be funded through individually-owned annuity contracts.²⁰ These individually-owned annuity contracts are indistinguishable from distributed annuity contracts. Both types of contracts are subject to the same qualification requirements, including, for example, the minimum distribution and spousal consent requirements. This similarity is even more accentuated in the context of section 403(b) arrangements where it is very common to fund the arrangement through individually-owned annuity contracts. The terms and requirements applicable to these contracts are indistinguishable from the terms and requirements applicable to a section 403(b) contract that is distributed in connection with the termination of a section 403(b) arrangement. For these reasons, the Committee recommends that final regulations confirm that pre-tax and Roth accounts held under a distributed annuity contract retain the tax character these accounts had while held in a plan after the contract has been distributed from the plan.

III. Final regulations should clarify the tax treatment of designated Roth accounts maintained under multiple section 403(b) annuity contracts issued in connection with the same plan

The Committee believes that revisions to the Proposed Regulations are needed in order to clarify the tax treatment of distributions from multiple designated Roth accounts maintained under the same section 403(b) arrangement. In this regard, section 402A(d)(4) states that “[s]ection 72 shall be applied separately with respect to distributions and payments from a designated Roth account and other distributions and payments from the plan.” Thus, this provision, which is titled “aggregation rules,” actually sets forth a non-aggregation rule by prohibiting the aggregation of Roth and non-Roth accounts for purposes of section 72. The statute does not, on its face, require the aggregation of multiple designated Roth accounts maintained under the same plan.²¹ However, the Committee is concerned that the Proposed

1.401(a)(31)-1, Q&A-17 (direct rollover requirements); Treas. Reg. section 1.411(d)-4, Q&A-2(a)(3)(ii) (prohibition against cutbacks in rights).

²⁰ See Treas. Reg. section 1.401-9(c) (interpreting Code section 401(g)).

²¹ Similarly, there is no statutory provision that requires the aggregation of multiple section 403(b) contracts for purposes of section 72. While section 403(b)(5) states that “[i]f for any taxable year of the employee [section 403(b)] applies to two or more annuity contracts issued by the employer, such contracts shall be treated as one contract,” the long-standing regulations under section 403(b) – which taxpayers and the Service have relied upon for decades – properly interpret this statutory provision as applying only with respect to the treatment of contributions made to two or more annuity contracts in the same year. See Treas. Reg. section 1.403(b)-1(b)(4). The treatment of multiple section 403(b) annuity contracts as separate

(continued ...)

Regulations could be read to impose such an aggregation rule. In this regard, Q&A-9(a) of Prop. Treas. Reg. section 1.402A-1 states that –

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.

It is unclear whether the Treasury Department and the Service intended this aggregation rule to apply to situations where designated Roth accounts are maintained under multiple section 403(b) annuity contracts. If such a rule was intended in that context, the Committee respectfully submits that the rule has no statutory basis and should not be included in the final regulations. Moreover, such an aggregation rule would be inconsistent with the federal income tax withholding and reporting requirements applicable to section 403(b) annuity contracts, including such contracts under which designated Roth accounts are maintained. Those withholding and reporting requirements are governed by sections 3405 and 6047(d), respectively.

In this regard, section 6047(d) requires that information returns be filed in connection with any contract under which designated distributions may be made in such form and in such manner as required by the Secretary of the Treasury. Temp. Treas. Reg. section 35.3405-1T, Q&A-E8, provides the general rule that information reporting under section 6047(d) is required any time there is a designated distribution to which section 3405 applies. A designated distribution is defined in section 3405(e)(1) generally as the taxable portion of any distribution or payment from or under a commercial annuity contract, which includes a section 403(b) annuity contract.²²

contracts for tax purposes also is recognized by Treas. Reg. section 1.403(b)-3, Q&A-4 (promulgated in April 2002), which provides that required minimum distributions under section 401(a)(9) are determined separately for each section 403(b) annuity contract that an individual owns (this rule was previously provided in Notice 88-38, 1988-1 C.B. 524). To the extent that the proposed regulations under section 403(b) that were promulgated in November 2004 suggest that multiple section 403(b) annuity contracts must be aggregated for purposes of section 72, the Committee respectfully submits that those regulations are inconsistent with the statute.

²² Temp. Treas. Reg. section 35.3405-1T, Q&A-A20.

As a general matter, section 3405 requires that federal income tax be withheld by the “payor” of any designated distribution. An exception is provided in the case of certain types of plans (hereinafter, “qualified plans”), which do not include section 403(b) plans. Under the exception for qualified plans, the “plan administrator,” rather than the payor, generally is responsible for withholding.²³ The income tax withholding procedures that apply and the taxable portion of a designated distribution are determined at the time the distribution is made. Thus, at such time, the party responsible for withholding must be able to accurately calculate the required tax so that the proper amounts can be withheld and reported. In the case of a non-qualified distribution from a designated Roth account maintained under a qualified plan, the party that must be able to make these calculations is the plan administrator. However, in the case of a non-qualified distribution from a designated Roth account maintained under a section 403(b) annuity contract or custodial account, the party that must be able to make these calculations is the payor, *e.g.*, the issuer of the section 403(b) annuity contract.

In this regard, if the aggregation rule described above is retained in the final regulations, it will be virtually impossible for the issuer of a section 403(b) annuity contract under which a designated Roth account is maintained to comply with the foregoing withholding and reporting requirements. In order to comply with the proposed aggregation rule, an issuer of a section 403(b) annuity contract with a designated Roth account would need to know whether a contract owner also holds one or more other section 403(b) annuity contracts under which designated Roth accounts are maintained. If this is the case, the issuer also would need to know, at a minimum, the total value and total “investment in the contract” held in such other accounts in order to properly report and withhold. This is illustrated by the following example –

Example. Employer maintains a 403(b) plan with 15 payroll slots that allow a total of 15 insurance companies and mutual fund companies to offer 403(b) annuity contracts and custodial accounts under the plan. Employer allows its employees to allocate and re-allocate their contributions and earnings among the available contracts and accounts, which employees routinely do in order to take advantage of a variety of different product features, *e.g.*, rates of return, available investment options, and available payout options. In Year 1, Employer decides to allow a designated Roth account under the plan. All 15 existing providers agree to offer designated Roth accounts under the contracts and accounts they make available to participants. In Year 1, Employee elects to designate a portion of her 403(b) elective deferrals as Roth

²³ Section 3405(d). *See also* Temp. Treas. Reg. section 35.3405-1T, Q&A-A13. The rule that imposes withholding responsibility on the plan administrator does not apply if the plan administrator (i) directs the payor to withhold the required tax and (ii) “provides the payor with such information as the Secretary may require by regulations.” Section 3405(d)(2)(A). In such cases, the regulations require the plan administrator to provide the payor with information needed to properly calculate the taxable amount of distributions. *See* Temp. Treas. Reg. section 35.3405-1T, Q&A-E3.

contributions and to allocate these contributions among 3 of the 15 section 403(b) annuity contracts offered under the plan.

In Year 3, Employee takes a non-qualified distribution from the designated Roth account maintained under the section 403(b) annuity contract issued by Company X. A portion of the distribution will be taxable under section 72, and Company X will be required to calculate such taxable portion at the time the distribution is made in order to satisfy its tax withholding and reporting obligations. As a result of the proposed aggregation rule, Company X will need to know that Employee owns two other designated Roth accounts and will need to obtain the account values and the investment in the contract as of the date of the distribution with respect to those other accounts because such information will affect the manner in which Company X is required to calculate the taxable portion of the distribution.

In effect, the aggregation requirement of Q&A-9(a) would mean that all life insurance companies that issue section 403(b) annuity contracts and all custodians that provide section 403(b) custodial accounts under a particular employer's plan would need to design, create, maintain, and share a database that contains all of the relevant contract value information for every contract or account maintained in connection with the plan. Moreover, because such values under a variable annuity contract or custodial account invested in mutual funds can fluctuate on a daily basis, and because distributions that affect such values can occur at any time, the database shared among all issuers and custodians would need to be updated in real time. Because prior and existing laws have never imposed such an aggregation rule, no shared database systems like this exist in the 403(b) market. Moreover, creating them would be extremely expensive, time-consuming, and perhaps even impossible under state and federal privacy laws.

In short, the proposed aggregation rule is inconsistent with income tax withholding and reporting requirements that the Code and regulations impose on issuers of section 403(b) annuity contracts and custodians of section 403(b) custodial accounts. Moreover, the proposed aggregation rule, if retained, would create a whole host of additional legal questions that would need to be addressed and resolved before it could be implemented. For example, if an individual owns two section 403(b) annuity contracts and each includes a designated Roth account, and the individual then elects an annuity distribution option (*e.g.*, a life annuity) with respect to the Roth account under one of the contracts, will the payments constitute "amounts received as an annuity" given the fact that the amounts in the other Roth account have not been annuitized? These types of questions, along with the fact that the proposed aggregation rule is not supported by the statute, argue strongly in favor of removing the rule from the final regulations. However, if the proposed rule is retained, then immediate guidance will be needed to clarify how issuers and custodians of section 403(b) annuity contracts and custodial accounts can satisfy their income tax withholding and reporting obligations. In such case, the Committee requests that Q&A-9(a) be revised to read as follows:

In applying the rules of sections 72, for purposes of income tax withholding and information reporting under sections 3405 and 6047, respectively, including any obligation to track an employee's 5-taxable year period for a qualified distribution, and for purposes of applying the eligible rollover distribution rules to a distribution from a designated Roth 403(b) account, a payor shall treat the designated Roth account from which a distribution is made as a separate contract and as the only designated Roth 403(b) account with respect to such individual. In such case, a payee shall make returns and reports regarding such account in such form, at such time, and containing such information as the Secretary may prescribe by forms or regulations.

Related to the foregoing issue, section 1.402A-2, Q&A-1, of the Proposed Regulations requires the "plan administrator or other responsible party" to track an employee's 5-taxable-year period of participation and investment in the contract under a designated Roth account. In the case of rollovers from such an account, Q&A-2 of that same section requires the "plan administrator or other responsible party" to provide certain statements regarding the status of the distribution as a qualified distribution or indicating the first year of the employee's 5-taxable-year period and the portion of the distribution that is attributable to investment in the contract. The Proposed Regulations do not define the term "other responsible party." Accordingly, the Committee requests clarification whether these requirements are intended to be imposed upon annuity issuers. If they are, the Committee also requests that final regulations clarify that the issuer may satisfy these requirements by providing information based solely on the annuity or annuities it provides with respect to the employee in question. In this regard, for the reasons described above, annuity issuers generally will have no way to know this information other than in connection with the annuity contracts that they actually issue.

IV. Required amendments and other issues

In addition to the foregoing issues that particularly affect annuity contracts and the issuers thereof, the Committee has identified several other issues that are more general in nature, but that still involve the application of the new rules to situations involving annuity contracts. Some of these additional issues on which guidance would be helpful are identified below for your consideration:

- *401(k) Plan Amendments*—Under Revenue Procedure 2005-66, 2005-37 I.R.B. 509, amendments to reflect the adoption of a Roth feature by a 401(k) plan will be required by no later than the end of the plan year in which the Roth feature is effective. As a result, for example, a calendar year plan that implements a Roth feature on June 1, 2006, would have until December 31, 2006, to adopt conforming plan amendments. It is not uncommon for an annuity contract that funds a 401(k) plan to reflect certain plan qualification requirements and it may be that amendments to reflect the addition of a Roth feature will have to be made to the annuity contract. Guidance should clarify that, in the case of an insurance company that must seek state approval before amending its annuity contract forms to comply with the new rules governing designated Roth contributions to a 401(k)

plan, the contract amendment will be deemed timely if (1) the issuing life insurance company submits proposed contract amendments for approval by the relevant state insurance departments by the later of (i) 90 days after the general effective date of the final regulations or (ii) the last date by which plan amendments reflecting the implementation of a Roth feature are required and (2) the contracts are administered in accordance with applicable rules from the general effective date of final regulations.

- *403(b) Plan Amendments*—For section 403(b) arrangements, there is no deadline for adopting plan amendments to reflect the addition of a Roth feature since section 403(b) does not currently require a written plan document. While proposed regulations under section 403(b) would impose a written plan document requirement, these regulations have not yet been finalized and the Service has yet to issue any guidance addressing the time frame for complying with any plan document requirement. If the final regulations under section 403(b) include a written plan document requirement, guidance should provide that the deadline for implementing plan provisions reflecting the addition of a Roth feature will be no earlier than the deadline for adopting a written plan document generally. By way of illustration, if the final 403(b) regulations include a written plan document requirement and plan documents need to be in place, for example, by no later than December 31, 2007, guidance should clarify that provisions reflecting a Roth 403(b) feature need to be in place by that same deadline. Correspondingly, guidance should clarify that any contract amendments that must be submitted for approval to state insurance departments in connection with a Roth arrangement will be considered timely if submitted by the general plan document deadline. Under this approach, in the illustration above, a section 403(b) arrangement that adopts a Roth 403(b) feature during 2006 would have until December 31, 2007 to adopt conforming plan amendments and issuers would have until December 31, 2007 to submit proposed contract provisions to state insurance departments.
- *Loans*—The Proposed Regulations indicate that a loan default cannot be a qualified distribution even if the default (and associated imputed income event) occurs at a time when the distribution would otherwise be considered qualified. The Committee is not aware of any basis for this position in either the statute or the legislative history and respectfully suggests that the Service reconsider this aspect of the proposed regulation. The approach taken in the Proposed Regulations with respect to deemed distributions due to a loan default will create a trap for unwary plan participants, disadvantage participants generally, and add yet another layer of complexity to an already difficult set of regulations. If this approach is included in the final regulations, at a minimum, the Service should clarify that a loan default attributable to Roth amounts is taxed in the same manner as any other nonqualified distribution. Affected participants should not be subject to tax on the entire deemed distribution but rather should be entitled to a pro rata recovery of basis as in any other nonqualified distribution. Finally, as we noted in our prior comment letter, guidance should also clarify that the section 403(b) annuity contract and the issuer's loan procedures govern in determining

whether a Roth account or non-Roth account will secure a contract loan (and, hence, to which account repayments will be credited).

- *Hardship Distributions*—Guidance should clarify that a hardship distribution may be a qualified distribution if the distribution otherwise satisfies the applicable requirements. In this regard, the Proposed Regulations refer to the list of distributions in Treasury Regulation 1.402(c)-2, A-4 and indicate that these distributions cannot be qualified distributions because they are not eligible rollover distributions. While hardship distributions are not included in the list of “deemed” nonqualified distributions, hardship distributions are not eligible rollover distributions and, for this reason, there has been some confusion regarding whether hardship distributions can be qualified distributions. The Committee reads the Proposed Regulations to provide that hardship distributions may be qualified distributions but believe that an explicit statement to this effect would be appropriate and helpful.
- *60-Day Rollovers*—The Proposed Regulations would require “a plan qualified under section 401(a), or a section 403(b) plan” that accepts a 60-day rollover of amounts attributable to a designated Roth account to notify the Service of its acceptance of the rollover by the due date for filing Form 1099-R. The Proposed Regulations are silent, however, on whether this reporting obligation is imposed on the plan administrator or the entity that receives the rollover, such as an insurance company. The Committee respectfully recommends that the final regulations clarify that this requirement is imposed on the plan administrator unless the entity that receives the rollover accepts responsibility for such reporting pursuant to an agreement with the plan administrator.

* * * * *

The Committee appreciates this opportunity to comment on the Proposed Regulations and looks forward to working with the Treasury Department and the Service regarding the points raised in these comments. If you have any questions or desire further information, please contact Joseph F. McKeever, III, Barbara N. Seymon-Hirsch, Jason K. Bortz, or Bryan W. Keene by phone at 202-347-2230, or by electronic mail at jfmckeever@davis-harman.com, bnseymon@davis-harman.com, jkbortz@davis-harman.com, or bwkeene@davis-harman.com (respectively).

Attachment

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Aegon USA Inc., Baltimore, MD
Allmerica Financial Company, Worcester, MA
Allstate Financial, Northbrook, IL
American International Group, Inc., Wilmington, DE
AmerUs Annuity Group Co., Topeka, KS
AXA Equitable Life Insurance Company, New York, NY
F & G Life Insurance, Baltimore, MD
Fidelity Investments Life Insurance Company, Boston, MA
Genworth Financial, Richmond, VA
Great American Life Insurance Co., Cincinnati, OH
Guardian Insurance & Annuity Co., Inc, New York, NY
Hartford Life Insurance Company, Hartford, CT
ING North America Insurance Corporation, Atlanta, GA.
Jackson National Life Insurance Company, Lansing, MI
John Hancock Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Lincoln Financial Group, Fort Wayne, IN
Merrill Lynch Life Insurance Company, Princeton, NJ
Metropolitan Life Insurance Company, New York, NY
Nationwide Life Insurance Companies, Columbus, OH
New York Life Insurance Company, New York, NY
Northwestern Mutual Life Insurance Company, Milwaukee, WI
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
The Phoenix Life Insurance Company, Hartford, CT
Protective Life Insurance Company, Birmingham, AL
Prudential Insurance Company of America, Newark, NJ
Sun Life of Canada, Wellesley Hills, MA
USAA Life Insurance Company, San Antonio, TX

The Committee of Annuity Insurers was formed in 1982 to participate in the development of federal tax policy with respect to annuities. The member companies of the Committee represent over half of the annuity business in the United States.