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# In General

Rollover Rules after EGTRRA 2001

Effective for distributions after December 31, 2001, EGTRRA 2001 increased the portability of retirement plan assets by opening up the rollover rules to allow rollovers to and from an expanded list of retirement plans, including 403(b) tax sheltered annuities, and by relaxing other restrictions, as follows:

(1) The Act adds Section 403(b) tax sheltered annuities to the list of eligible retirement plans that may receive a distribution *from* a qualified plan. IRC Sec. 402(c)(8)(B), as amended by EGTRRA 2001, Secs. 641(a)(2), 641(b)(2). However, in order to preserve capital gains and special averaging treatment for a qualified plan distribution, a distribution from a qualified plan would still need to be made to a "conduit IRA" as under the old rules and rolled back over to another qualified plan. The money from the qualified plan cannot be commingled with money from other sources for these purposes. EGTRRA 2001, Secs. 641(f)(3), 642(c)(2).

(2) The Act adds qualified plans and eligible Section 457 governmental plans to the list of eligible retirement plans that may receive a distribution *from* a Section 403(b) tax sheltered annuity. IRC Sec. 403(b)(8)(A)(ii), as amended by EGTRRA 2001, Sec. 641(b)(1).

(3) The Act removes several restrictions on rollovers *to* qualified plans and Section 403(b) tax sheltered annuities. A distribution from a SIMPLE IRA may be rolled over to any eligible retirement plan after the first two years of participation; during the first two years of participation, a distribution from a SIMPLE IRA may be rolled over only to another SIMPLE IRA. IRC Secs. 408(d)(3)(A), 408(d)(3)(G), as amended by EGTRRA 2001, Secs. 642(a), 642(b)(3). (4) The Act clarifies that after-tax contributions (including nondeductible contributions to a traditional IRA) may not be rolled over *from* a traditional IRA into a 403(b) tax sheltered annuity. IRC Secs. 402(c)(2), 408(d)(3)(A), as amended by EGRRRA 2001, Secs. 643, 642(a).

(5) The Act provides a hardship exception to the application of the 60-day rule for rollovers. IRC Secs. 402(c)(3), 408(d)(3)(I), as amended by EGTRRA 2001, Secs. 644(a), 644(b).

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Rollover Rules before EGTRRA 2001

Revised rollover rules applicable to tax sheltered annuity distributions received after 1992 were enacted by Congress in the Unemployment Compensation Amendments of 1992, P.L. 102-318. These revised rules generally state that if any portion of the balance to the credit of an employee in a qualified retirement plan is paid to the employee in an eligible rollover distribution, and the employee transfers any portion of the property received to an eligible retirement plan, then the amount of the distribution transferred is not includable in income. IRC Sec. 402(c)(1), as in effect for distributions received after December 31, 1992.

A slightly later effective date may apply to certain tax sheltered annuities. If, as of July 1, 1992, a state law prohibits a direct rollover from a tax sheltered annuity purchased for an employee by a government employer, the direct rollover requirements will not apply to distributions before the earlier of 90 days after the date on which such transfer is permitted under state law or January 1, 1994. P.L. 102-318, Sec. 522(d)(2); Treas. Reg. §1.403(b)-2, A-4; Temp. Treas. Reg. §1.403(b)-2T, A-4(b) (as in the 4/1/95 Code of Federal Regulations; removed 10/19/95 but apparently still effective by virtue of reference in final regulations).

Rollover distributions from tax sheltered annuities may be made to either another tax sheltered annuity or to an individual retirement plan (except for a Roth IRA, as discussed below). IRC Sec. 403(b)(8). Such a distribution may not be rolled over to a qualified pension, profit sharing or stock bonus plan. Thus, where a taxpayer used the majority of a cash distribution from her tax sheltered annuity to purchase additional years of service credit in her pension plan the purchase amount did not qualify for rollover treatment since the funds were not placed in either an individual retirement plan or another tax sheltered annuity. *Tolliver v. Comm.*, TC Memo 1991-460. A proper rollover was not achieved where a taxpayer invested a tax sheltered annuity distribution in a certificate of deposit. *Adamcewicz v. Comm.*, TC Memo 1994-361. Furthermore, amounts held in an annuity contract or contract described in Section 403(b) *cannot* be converted directly to a Roth IRA. Prop. Treas. Reg. §1.408A-4, A-5.

A distribution of property other than money is treated in the same manner. The amount transferred equals the property distributed. IRC Sec. 402(c)(1)(C), as in effect for distributions received after December 31, 1992. A taxpayer may not retain the property received in the distribution and simply roll over a cash amount representing the fair market value of the property. Rev. Rul. 87-77, 1987-2 CB 115. Where a distribution includes property and exceeds the rollover contribution, the participant, following a sale, may designate (irrevocably) which portion of the money received, and which portion of

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the proceeds of the sale, are to be treated as included in the rollover and which portions are to be deemed attributable to nondeductible employee contributions, if any. If he fails to make a designation, allocations will be made on a ratable basis. IRC Sec. 402(c)(6), as in effect for distributions received after December 31, 1992.

 Under the basis recovery rules of Section 72(e), the nondeductible employee contributions are recovered first from the amounts not rolled over. Notice 87-13, 1987-2 CB 432, A-18; Let. Rul. 9043056.Generally, the maximum amount that may be rolled over is the amount which would be includable in income if not rolled over. IRC Sec. 402(c)(2), as in effect for distributions received after December 31, 1992. If any portion of a transferred amount is deemed to be nondeductible employee contributions and, thus, not a rollover contribution, the remaining portion is still eligible for rollover treatment. See Rev. Rul. 89-50, 1989-2 CB 631.

The Service has indicated that amounts that are not eligible for distribution from a Section 403(b) annuity due to the distribution restrictions of Section 403(b)(11) cannot be rolled over into an IRA or another TSA. However, such amounts may be transferred between tax sheltered annuities if the requirements of Revenue Ruling 90-24, 1990-1 CB 97, are met (and provided the plans permit such transfers). IRS Information Letter, May 19, 1995. Presumably, the IRS would feel the same about amounts that are not eligible for distribution from a tax sheltered annuity by reason of the distribution restrictions of Code section 403(b)(7) (applicable to custodial accounts).

As with the rules effective for pre-1993 distributions, a rollover must be completed within sixty days after the distribution is received. IRC Sec. 402(c)(3). However, in contrast to the pre-1993 rules, unless a rollover is effected by means of a direct rollover, the distribution amount will be subject to a mandatory income tax withholding of 20%. IRC Sec. 403(b)(10), as amended by P.L. 102-318, Secs. 522(a)(3), 522(c)(3); IRC Sec. 3405(c)(1), as added by P.L. 102-318, Sec. 522(b)(1).

Following the Unemployment Compensation Amendments of 1992, the IRS issued temporary regulations to provide guidance on the changes in the rules governing rollovers. See generally Temp. Treas. Reg. §1.403(b)-2T. In 1995, the IRS issued final regulations effective for distributions made on or after October 19, 1995. See generally Treas. Reg. §1.403(b)-2. Generally, the temporary regulations remain applicable to distributions received on or after January 1, 1993 but before October 19, 1995. However, for any distribution received in this time period, any or all of the provisions of the final regulations may be substituted for the corresponding provisions of the temporary regulations. Treas. Reg. §1.403(b)-2, A-4. References in this discussion are generally to the final regulations.

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# Distributions Eligible for Rollover Treatment

Generally, a distribution of any portion of the balance of the credit of an employee in a qualified retirement plan is eligible for rollover treatment to the extent that it is paid to the employee in the form of an *eligible rollover distribution* and the distributee transfers any portion of the property to an *eligible retirement plan*.

The amount of such a distribution is not includable in income in the year the distribution is made. IRC Sec. 402(c)(4). See also Treas. Reg. §1.403(b)-7(b)(1).

Eligible Rollover Distribution

Generally, an “eligible rollover distribution” is defined as any distribution made to an employee of any portion of the balance to the credit of the employee, except that the term does not include (1) any distribution that is part of a series of substantially equal payments made over the life expectancy of the employee or the joint life expectancies of the employee and his or her spouse, (2) any distribution made for a specified period of ten years or more, and (3) generally any hardship distribution. IRC Secs. 402(c)(4), 408(b)(8)(B).

Regulations specify other items not considered to be eligible rollover distributions including any portion of a distribution excludable from gross income, the Table 2001 (or P.S. 58) cost of life insurance, and corrective distributions of excess deferrals and excess employer matching contributions. Treas. Regs. §§1.402(c)-2, A-3, 1.402(c)-2, A-4. Also ineligible for rollover treatment is any distribution that is a required minimum distribution under Section 401(a)(9). IRC Sec. 402(c)(4)(B).

For purposes of the rollover rules, loans that are “deemed distributions” and loans that are “offset amounts” are treated differently. A deemed distribution occurs when the requirements of Section 72(p) are not satisfied, either when the loan is made or at some later time, such as when the loan is in default because it is not repaid in a manner that satisfies Section 72(p). It is treated as a distribution only for federal income tax purposes and is not a distribution of the participant’s accrued benefit. A distribution of an offset amount occurs when, under the terms governing the plan loan, the participant’s accrued benefit is reduced in order to repay the loan.

A deemed distribution is not an eligible rollover distribution. Thus, it will not be subject to the direct rollover and mandatory withholding rules. Treas. Regs. §§1.402(c)-2, A-4, 31.3405(c)-1, A-1(a); Treas. Reg. §1.72(p)-1, A-12; see also Notice 93-3, 1993-1 CB 293. Plan loan offset amounts can be eligible rollover distributions. Treas. Reg. §1.402(c)-2, A-9; see also Notice 93-3, above. A plan will not fail to satisfy the direct

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rollover option requirement merely because a plan does not permit a participant to elect a direct rollover of an offset amount that is an eligible rollover distribution. Treas. Reg. §1.401(a)(31)-1, A-15; see also Notice 93-3, above. A participant may, however, roll over an amount equal to the offset amount (if it is in fact an eligible rollover distribution) to an eligible retirement plan within 60 days. Treas. Reg. §1.402(c)-2, A-9; see also Notice 93-3, above.

Eligible Retirement Plan

The definition of "eligible retirement plan" depends on the plan from which the rollover is made. The availability of rollovers between various types of plans was considerably expanded by EGTRRA 2001, for purposes of distributions occurring after 2001.

For distributions *from* an IRC Section 403(b) tax sheltered annuity, an eligible retirement plan includes a traditional IRA, a qualified plan, a 403(a) annuity, an eligible IRC Section 457 governmental plan (provided it agrees to separately account for funds received from any eligible retirement plan, except another eligible Section 457 governmental plan), and another 403(b) annuity. IRC Secs. 403(b)(8)(A)(ii), 402(c)(10).

For purposes of distributions after 2001 from another type of retirement account, an IRC Section 403(b) tax sheltered annuity is an eligible retirement plan with respect to a qualified plan, a traditional IRA, or another IRC Section 403(b) tax sheltered annuity. See IRC Secs. 402(c)(8)(B), 402(c)(10), 401(a)(31)(D), 408(d)(3)(A).

# 20% Mandatory Withholding

Generally, unless a rollover is effected by means of a direct rollover, the distribution amount will be subject to a mandatory income tax withholding of 20%. IRC Sec. 403(b)(10); IRC Sec. 3405(c)(1).; Treas. Reg. §1.403(b)-7(b)(4).

A special rule for small distributions provides that eligible rollover distributions of less than $200 that are not directly rolled over are not subject to the withholding requirement. Treas. Reg. §1.401(a)(31)-1, A-11. All eligible rollover distributions received by a distributee within one taxable year under the same plan must be aggregated for purposes of determining whether the $200 floor is reached. Treas. Reg. §31.3405(c)-1, A-14.

The 20% withholding requirement is mandatory; the employee receiving the distribution may not elect out of the withholding requirement.

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If a participant receives an eligible rollover distribution that was subject to the 20% withholding rate, the 20% withheld will be includable in income (to the extent required by Section 403(b)(1)) even if the participant rolls over the remaining 80% of the distribution within the 60-day period. See Treas. Reg. §§1.402(c)-2, A-11.

Because the amount withheld is considered to be an amount distributed under Section 402(c), the participant may add an amount equal to the 20% withheld to the 80% he has received, resulting in a rollover of the full distribution amount. The 10% premature distribution penalty may apply to the amount withheld where only the remaining 80% of the distribution is rolled over. Treas. Reg. §1.402(c)-2, A-11.

Where a distributee elects to transfer a portion of the distribution by a direct rollover and receive the remainder, the 20% withholding requirement applies only to the portion of the distribution that the distributee actually receives. It does not apply to the portion of the distribution that is transferred directly to another eligible retirement plan. Treas. Reg. §31.3405(c)-1, A-6.

For purposes of determining the amount to be withheld in the case of a distribution of an offset loan amount, the total amount of the distribution, *including* the amount of any loan that is offset, must be multiplied by 20%; however, the total amount required to be withheld cannot exceed the sum of the cash and the fair market value of the property received by the participant, *excluding* any offset amount or any amount that is distributed in the form of employer securities. Treas. Reg. §31.3405(c)-1, A-11; see also Notice 93-3, 1993-1 CB 293.