

Legislative Alert

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Timely information to help you operate your retirement plan more efficiently

Roth 401(k) Final Regulations

On December 30, 2005, while most people were home for a 4-day weekend, the Internal Revenue Service (IRS) amended the current 401(k) rules by releasing the final regulations for plans wishing to adopt a Roth 401(k) feature.

What is a Roth 401(k)?

The Roth elective contribution is an option that an employer may add to its 401(k) program allowing participants to make after-tax contributions. This option is attractive because, unlike traditional after-tax contributions, "qualified distributions" of Roth 401(k) earnings are free from federal income tax. In exchange, the participant gives up the tax deduction for pre-tax elective contributions.

The Roth 401(k) is similar in concept to the Roth IRA because it provides the potential for the accumulation permanently tax-free assets. However it does not have many of the complications associated with the Roth IRA such as earnings limitations and conversion/re-conversion issues.

Enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Code Section 402A had a delayed effective date beginning with tax years starting after December 31, 2005. This means that beginning January 1, 2006 a 401(k) plan may be amended to permit participants to designate all or a part of their elective contributions as Roth contributions. Employers, however, are not required to offer this contribution feature.

Regulatory Requirements

The regulation defines Roth contributions as elective contributions that an employee makes under a tax-qualified cash or deferred arrangement that are:

- Irrevocably designated (at the time of the contribution) by the employee as Roth contributions, that are made in lieu of all or a portion of the pre-tax elective contributions the employee is otherwise eligible to make under the plan
- Treated by the employer as includible in the employee's gross income at the time the employee would have received the contribution amounts in cash if the employee had not made the cash or deferred election (e.g., by treating the contributions as wages subject to applicable withholding requirements).
- Maintained by the plan in a separate account

Plan document requirements

The plan document must specifically permit employees to designate elective contributions as designated Roth contributions. However, in related guidance, the IRS provides that an employer can implement designated Roth contributions beginning January 1, 2006, but need not amend the plan to provide for formal Roth contributions until the end of the plan year in which it adopted the Roth feature (see IRS Notice 2005-95). As an example, where the plan year ends on March 31, the employer can implement designated Roth contributions as early as January 1, 2006, but must amend the plan by March 31, 2006. The Notice further indicates that the IRS intends to issue a model amendment for designated Roth contributions.

Separate accounts

The final regulations clarify that no contributions other than designated Roth contributions and rollover contributions described in Code Section 402A(c)(3)(B)

can be allocated to a designated Roth account. This means that a plan may not allocate matching contributions, profit sharing contributions, safe-harbor contributions, and forfeitures to a Roth account.

The plan must maintain a separate bookkeeping account to reflect the Roth contributions and related earnings. The separate account must allocate gains, losses, and expenses on a reasonable and consistent basis for the designated Roth account and other accounts under the plan.

Designated Roth contributions must be non-forfeitable, and the distribution restrictions applicable to pre-tax elective contributions are applicable to Roth contributions as well.

Age 70½ rules

Designated Roth accounts are subject to the required minimum distribution rules of Code Section 401(a)(9) (A) and (B) in the same manner as pre-tax elective contributions. This is different from the Roth IRA, which does not apply these rules during the lifetime of the Roth IRA owner. However, a participant may obtain the Roth IRA exception to the age 70 ½ rules by rolling over a designated Roth account to a Roth IRA.

Nondiscrimination testing

Designated Roth contributions must satisfy the requirements applicable to pre-tax elective contributions. Therefore, a plan takes designated Roth contributions into account under the actual deferral percentage test (ADP test) of Code Section 401(k)(3) in the same manner as pre-tax elective contributions

Administrative issues

For the most part, the rules applicable to pre-tax elective deferrals apply to Roth 401(k) plans. However, an employer does not necessarily need to apply all rules in the same manner.

Types of accounts

A Roth 401(k) plan must offer both a designated Roth contribution option and pre-tax elective contribution option. This is consistent with the language in Code Section 402A stating that a plan may permit an employee to elect to make designated Roth contributions in lieu of all or a portion of the pre-tax elective contributions the employee is eligible to make.

Catch-up contributions

A plan may treat designated Roth contributions as catch-up contributions.

Frequency of elections and automatic enrollment

The requirement that a 401(k) plan provide employees with at least an annual election to make pre-tax elective contributions also applies to elections to make designated Roth contributions. A Roth 401(k) plan that provides for automatic enrollment must indicate to which extent the default contributions are pre-tax elective contributions or designated Roth contributions. If the default contributions are designated Roth contributions, then the plan deems an employee who has not made an affirmative election to have irrevocably designated the contributions as designated Roth contributions.

Corrective distributions

A plan may permit any highly compensated employee who must receive a corrective distribution for a year that includes both pre-tax elective and designated Roth contributions to elect whether the plan is to attribute excess contributions to pre-tax elective or designated Roth contributions. Alternatively, a plan may adopt an administrative rule to address the situation. For example, a plan may say that corrective distributions come from pre-tax deferrals first.

If a plan makes a corrective distribution of a designated Roth contribution, the amount distributed is not includable in the employee's gross income. However, the

income allocable to a corrective distribution of a designated Roth contribution is includible in gross income in the same manner as income allocable to a pre-tax elective contribution.

Loans, directed investments, distributions, and direct rollovers

The regulations do not restrict an employee from borrowing against his or her Roth contribution account or directing the investment of the account. Both loans and directed investments are available in the same manner as a pre-tax contribution account. Similarly, nothing in the regulations prevents a plan from permitting in-service distributions from designated Roth accounts.

To the extent a direct rollover is permitted under the rules of Code Section 402(c), a plan may permit a direct rollover from a designated Roth account. However, any such direct rollover may only be to another designated Roth account under another Roth 401(k) plan or to a Roth IRA.

EGTRRA sunset

As mentioned earlier, the Roth 401(k) is a product of the EGTRRA legislation. That legislation contains a sunset provision under which the provisions of EGTRRA do not apply to taxable, plan, or limitation years beginning after December 31, 2010.

The regulations indicate that the IRS will address any issues created by the EGTRRA sunset provision if the sunset becomes effective.

Future guidance

In addition to the upcoming model amendment, the IRS will address guidance on reporting the taxation of distributions that are not "qualified distributions". That guidance will come in the form of proposed regulations under Code Section 402A.

To learn more about Roth 401(k) features or RSM McGladrey Retirement Resources please call 888.RET.401K (888.738.4015) or visit us online at www.rsmmcgladrey.com/retirement.