

Client Alert

A report
for clients
and friends
of the firm **March 2006**

Internal Revenue Service Issues Guidance on Roth 401(k) and 403(b) Plan Arrangements

Recently, the Internal Revenue Service released final and proposed regulations on how to implement a Roth contribution feature in a 401(k) plan ("Roth 401(k) Contributions"). This Client Alert highlights some of the considerations that a plan sponsor should take into account before adding this optional feature to a plan and reviews key points clarified under the final regulations. Also, this Client Alert summarizes significant concepts addressed by the proposed regulations, including how a Roth arrangement may be added to a 403(b) plan.

The final regulations apply on and after January 1, 2006. Generally, the proposed regulations may be relied upon now, although certain provisions will not be effective until January 1, 2007.

The deadline to amend a plan to permit Roth contributions is the end of the plan year in which the plan amendment is effective. For example, if a plan sponsor wishes to add a Roth 401(k) arrangement to a calendar year plan in 2006, the plan sponsor must amend the plan by December 31, 2006.

Background

General. Under Section 402A of the Internal Revenue Code (the "Code"), a 401(k) plan may permit participants to designate some or all of their elective contributions to the 401(k) plan as Roth 401(k) Contributions. Unlike traditional 401(k) contributions that are contributed on a pre-tax basis, Roth 401(k) Contributions are contributed on an after-tax basis. Additionally, in contrast to earnings

on traditional 401(k) contributions which are taxed upon distribution from a plan, Roth 401(k) Contributions and their earnings are distributed tax-free.

Overall Limit. The same overall limit pursuant to Code Section 402(g) applies to all traditional pre-tax 401(k) contributions and/or Roth 401(k) Contributions. Thus, the total amount of a participant's pre-tax contributions plus Roth 401(k) Contributions in 2006 is limited to \$15,000 (plus an additional \$5,000 in catch-up contributions for participants who are at least age 50).

Roth IRAs – Similar but Different. The tax treatment of Roth IRAs is similar to that of Roth 401(k) Contributions (i.e., contributions are contributed on an after-tax basis and contributions and their earnings are distributed tax-free). There are, however, many differences between these types of arrangements. For example, while a traditional IRA may be converted into a Roth IRA, traditional pre-tax 401(k) contributions cannot be converted into Roth 401(k) Contributions.

Also, while Roth IRAs are not open to an individual whose modified adjusted gross income exceeds certain limits (e.g., for married joint filers, \$160,000; for an unmarried individual filer, \$110,000), Roth 401(k) Contributions are not restricted based upon modified adjusted gross income. This may interest highly paid employees who are ineligible to benefit from Roth IRAs.

Issues for Participants and Plan Sponsors

Both 401(k) plan participants and sponsors should consider the advantages and disadvantages of Roth 401(k) Contributions. These issues apply to 403(b) sponsors and participants as well.

Participants. The conventional wisdom has been that traditional 401(k) contributions provide an advantage to participants based upon the timing of taxation -- there is no tax at the time of deferral, the earnings

accumulate tax-deferred and although the contributions and earnings will be taxed at distribution, most people expect to be at a lower tax bracket at that time.

However, this advantage would be diminished in the event that an individual's tax bracket is not lower when distributions commence. Moreover, an individual may decide that he or she is better off being taxed up-front under a Roth 401(k) arrangement if that means that all of the earnings on contributions will be distributed tax-free. A participant making this analysis may find the following factors relevant: (1) the current tax rate; (2) what the tax rate is expected to be at the time of distribution; (3) the number of years the contributions will be invested until distribution; (4) the expected rate of return; and (5) the state of the law at the time of distribution. However, most of these factors are difficult to predict, and participants may be uncertain whether to make traditional 401(k) contributions or Roth 401(k) Contributions if both options are available to them.

In addition, even if a participant decides that, based on his or her situation, Roth 401(k) Contributions are a better strategy for the long run, making these contributions at the same level of pre-tax contributions in prior years may be financially difficult because of the additional tax that would be currently due.

Plan Sponsors. Plan sponsors must recognize that although Roth 401(k) Contributions may be attractive to current and potential employees, these contributions may create significant administrative challenges. First, a new taxation regime will need to be instituted for purposes of taxing and withholding on Roth 401(k) Contributions. Second, employers should recognize that, in addition to a plan amendment, appropriate election forms and employee communications will need to be prepared to properly explain the new rules to participants and to implement these arrangements. Third, the plan sponsor will need to confirm that its third party administrator can provide the administrative services necessary to implement and support a Roth 401(k) arrangement. Fourth, plan sponsors should consider that instituting a Roth 401(k) arrangement may result in changes to participation and contribution levels, and this may impact nondiscrimination testing. Finally, because a Roth 401(k) arrangement is a "benefit, right or feature" (as defined in the regulations under Code Section 401(a)), such an arrangement is subject to nondiscrimination testing.

The Final Regulations

The final regulations provide specific rules for purposes of implementing a Roth 401(k) arrangement:

- **Irrevocable Election.** Roth 401(k) Contributions are elective contributions that are irrevocably designated by

an employee as Roth 401(k) Contributions at the time of the cash or deferred election (i.e., when the employee completes a form authorizing salary reductions and contributions to a plan).

- **Gross Income Inclusion.** The employer includes Roth 401(k) Contributions 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.
- **Separate Account.** Roth 401(k) Contributions must be maintained in a separate account that is adjusted for gains and losses. Forfeitures and matching contributions are not permitted to be allocated to the Roth account.
- **Roth Only Plans Are Prohibited.** In order to provide for Roth 401(k) Contributions, a plan must also offer traditional pre-tax 401(k) contributions.
- **Must Satisfy Requirements Applicable To Elective Contributions.** Roth 401(k) Contributions are subject to the nonforfeitability and distribution restrictions applicable to traditional 401(k) contributions and are taken into account under the actual deferral percentage test, the "ADP" test. Similarly, Roth 401(k) Contributions may be treated as catch-up contributions and serve as the basis for a participant loan. The required minimum distribution rules apply to Roth 401(k) Contributions.
- **Automatic Enrollment.** A plan may utilize automatic enrollment in conjunction with Roth 401(k) Contributions. A plan must state the extent to which those default contributions are traditional pre-tax 401(k) contributions or irrevocable Roth 401(k) Contributions.
- **Direct Rollovers.** Roth 401(k) Contributions may be rolled over directly to a retirement plan that accepts Roth 401(k) Contributions or to a Roth IRA. A plan is permitted to treat a participant's Roth 401(k) account and the participant's other accounts under a plan as accounts held under two separate plans so that if a participant's Roth 401(k) balance is less than \$200, the plan is not required to offer a direct rollover of that amount.
- **Correcting Nondiscrimination Test Failure.** If excess contributions will be returned to a highly compensated employee ("HCE") in order to correct a plan's failed nondiscrimination test, the plan may permit the HCE to attribute the distribution to either his or her Roth 401(k) Contributions or traditional pre-tax 401(k)

contributions. Only income attributable to excess Roth 401(k) Contributions is taxable upon distribution.

The Proposed Regulations

The proposed regulations address a number of issues relating to Roth plan arrangements, including rules on taxation, rollovers, Roth 403(b) plans and reporting requirements.

Qualified Distributions. In general, the Code provides that a distribution of Roth 401(k) or 403(b) plan contributions and earnings will not be taxed if the distribution is made on or after the date on which the participant attains age 59½, dies or becomes disabled, as long as the distribution is not made within the five-taxable-year period beginning with the first taxable year (generally the calendar year) for which the individual made a Roth contribution under the plan. This tax-free distribution is known as a "qualified distribution."¹

Taxation of Distributions. The proposed regulations include technical rules on the taxation of earnings on distributions that are not qualified distributions.

Rollovers to and from Roth 401(k) or 403(b) Plan Accounts. Rollovers to and from Roth 401(k) or 403(b) plan accounts are permitted as follows:

- If the Roth contributions were rolled over from a different Roth 401(k) or 403(b) plan, the participant may begin counting the five-taxable-year period since the first Roth contribution was made to the other plan. The proposed regulations clarify that if an employee has Roth contributions under two separate plans, each plan calculates the five-taxable-year period independently for purposes of a distribution, unless there is a rollover between the plans.
- The tax-free portion of a Roth 401(k) distribution (i.e., the contribution and, subject to the five-taxable-year period requirement, earnings) can be rolled over directly to another qualified plan that separately accounts for the tax-free portion, but not to a Section 403(b) plan. Similarly, the tax-free portion of a Roth 403(b) distribution can be rolled over directly to another Roth 403(b) plan that separately accounts for the tax-free portion, but not to a qualified plan. An indirect rollover by an employee within 60 days of distribution is not permitted to either type of plan.
- The tax-free portion of a distribution can be rolled over to a Roth IRA in either a direct rollover or an indirect 60-day rollover. However, in the case of a rollover to a Roth IRA, the period that the funds were in the Roth 401(k) or 403(b) plan does not count towards the Roth IRA's five-taxable-year period needed for tax-free distributions.
- The taxable portion of a distribution (i.e., in the case of a distribution that is not a qualified distribution) from a Roth plan account may be rolled over directly or indirectly to another Roth plan account, but the period of participation under the distributing plan is not carried over to the recipient plan for purposes of satisfying the five-taxable-year period rule.
- Rollovers from Roth IRAs to Roth 401(k) or 403(b) plans are not permitted.

Universal Availability – Roth 403(b) Plans. The proposed regulations clarify that the rules applicable to Roth 401(k) plan arrangements generally also apply to Roth 403(b) plan arrangements. However, Section 403(b) plans are unique in that they have a universal availability requirement. This means that if one employee has the right to make Roth contributions to a Section 403(b) plan, all other employees must have the same right.

Hardships and Employer Securities. The proposed regulations also address the treatment of hardships and employer securities in the context of Roth plan accounts.

Recordkeeping and Reporting. The proposed regulations provide the following recordkeeping and reporting rules that are effective for taxable years beginning on or after January 1, 2007.

- Within 30 days of a direct rollover to a Roth plan account, the plan administrator making the rollover must provide the recipient plan with either a statement indicating the first year of the five-taxable-year period and the portion of the distribution that is attributable to after-tax Roth plan contributions, or a statement that the distribution is a qualified distribution.
- In the case of an indirect rollover, within 30 days of a participant request, the plan administrator must provide the participant with a statement indicating the portion of the distribution that is attributable to after-tax Roth

¹ Distributions that cannot be qualified distributions include a distribution of elective deferrals exceeding the Code Section 415 limit (\$44,000 in 2006), a corrective distribution of deferrals exceeding the Code Section 402(g) limit (\$15,000 in 2006), a corrective distribution of excess contributions or excess aggregate contributions needed to pass the nondiscrimination tests, a deemed distribution due to a loan default or the cost of current life insurance protection, and dividends deductible under Code Section 404(k) except in certain cases where they are reinvested in employer securities.

plan contributions, or a statement that the distribution is a qualified distribution.

- If a 401(k) or 403(b) plan accepts an indirect rollover contribution of taxable earnings from another Roth 401(k) or 403(b) plan, respectively, the recipient plan administrator must, no later than the due date for filing IRS Form 1099-R, provide the IRS with notice of the employee's name and social security number, the amount rolled over, the year in which the rollover contribution was made and any other information required by the IRS.
- The reporting and record keeping requirements are proposed to be effective beginning with the 2007 taxable year. However, the IRS cautions plan administrators that it will not be possible for a plan to comply with the guidance (e.g., the separate accounting requirement) without keeping track of each employee's investment under a Roth plan account this year.

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While the IRS has issued some suggested language (in the most recent Listing of Required Modifications) which addresses Roth plan arrangements, the IRS is also expected to release model language to better assist plan sponsors who wish to adopt Roth plan arrangements.

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