

# Client Alert

A report  
for clients  
and friends  
of the Firm August 2007

## Roth 401(k) and Roth 403(b) Plan Arrangements: The Internal Revenue Service Issues New Final Regulations

Recently, the Internal Revenue Service released final regulations relating to Roth contribution accounts in 401(k) and 403(b) plans ("Roth Accounts"). In addition to modifying and finalizing earlier proposed regulations, the final regulations provide comprehensive guidance on the taxation of distributions from, and reporting requirements relating to, Roth Accounts.<sup>1</sup> This Client Alert summarizes significant changes, clarifications and additions to the guidance provided under the final regulations.

The final regulations are effective immediately and generally apply to taxable years beginning on or after January 1, 2007, although certain provisions apply earlier.

### Background

Under Section 402A of the Internal Revenue Code (the "Code"), a 401(k) plan or 403(b) plan may permit a participant to designate some or all of his or her elective contributions under the plan as contributions to a Roth Account ("Roth Contributions"). Unlike traditional 401(k) or 403(b) contributions that are contributed on a pre-tax basis, Roth Contributions are contributed on an after-tax basis.

Additionally, in contrast to a distribution of traditional 401(k) or 403(b) contributions and earnings which are taxed upon distribution from a plan, a "qualified distribution" of Roth Contributions and earnings from a Roth Account is generally distributed tax-free. In general, a "qualified distribution" is a distribution from a Roth Account that 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.

Roth Accounts are also different from Roth IRAs. For example, a Roth IRA is not open to an individual whose modified adjusted gross income exceeds certain amounts (e.g., for 2007, the limit is \$166,000 for married joint filers and \$114,000 for unmarried individual filers). In contrast, Roth Accounts are not restricted based upon modified adjusted gross income.

### The Final Regulations

**Qualified Distributions.** The final regulations clarify that, in the case of distribution to an alternate payee or beneficiary, the age, death or disability of the participant (and not the alternate payee or beneficiary) is used to determine whether the distribution is qualified. The only exception is in the case of a rollover, by an alternate payee or surviving spouse, to a Roth Account under a plan of his or her own employer.

**Determination of 5-Taxable-Year Period for Qualified Distributions.** The final regulations clarify various aspects of the 5-taxable-year period for qualified distributions.

- Roth Contributions made by a reemployed veteran under Code Section 414(u) are treated as made in the taxable year with respect to which the contributions relate. For example, re-employed veterans may identify the year for which a contribution is made for other purposes, such as for entitlement to a match, and

<sup>1</sup> For a summary of the final and proposed regulations previously released on this issue, please see our Client Alert entitled "Internal Revenue Service Issues Guidance On Roth 401(k) And 403(b) Plan Arrangements" at [http://www.proskauer.com/news\\_publications/client\\_alerts/content/2006\\_03\\_29](http://www.proskauer.com/news_publications/client_alerts/content/2006_03_29)

the treatment for the 5-taxable-year period rule follows that identification. Absent such an identification, the Roth Contribution is treated as made in the veteran's first taxable year in which the qualified military service begins, or if later, the first taxable year in which Roth Contributions could be made under the plan.

- Certain contributions do not start the 5-taxable-year period of participation. For example, a year in which the only contributions consist of excess participant contributions that are returned to the participant to comply with certain legal limits will not start the 5-taxable-year period of participation.
- Commentators requested that the IRS treat distributions from Roth Accounts on account of hardship like distributions from Roth IRAs which are a return of contributions (and thus not includible in gross income) until all contributions have been returned. Relying on statutory construction, the IRS refused this request. Therefore, the final regulations retain the proposed rule where a portion of each hardship distribution from a Roth Account is a return of contributions that is non-taxable, and the balance is a return of earnings that is taxable.

#### **Rollovers of Roth Contributions.**

The final regulations clarify that a Roth Account may only include accounts under a plan to which Roth Contributions are made in lieu of elective pre-tax contributions. Therefore, a distribution from a Roth Account may only be rolled over to a 401(k) or 403(b) plan that has a designated Roth program.

Additionally, a participant who wishes to roll over an amount that is not includible in gross income from a Roth Account under one plan into a Roth Account under another plan may only accomplish this through the use of a direct rollover (i.e., an indirect rollover from an employee within 60 days is not available).

However, if a distribution from a Roth Account is made to an employee, the employee is still able to roll over the entire amount (or any portion thereof) into a Roth IRA within a 60-day period.

#### **Determination of 5-Taxable-year Period After a Rollover to a Roth IRA.**

Although Roth Accounts and Roth IRAs each generally require 5-taxable-year holding periods for purposes of avoiding taxes on distributions, different rules apply to each for determining when the 5-taxable-year requirement is satisfied. Generally, for Roth Accounts, the 5-year period begins when a Roth Contribution was first made by the employee under that plan. In contrast, for Roth IRAs, the 5-year period begins with the first taxable year for which a contribution is made to any Roth IRA.

In the case of a rollover of a distribution from a Roth Account to a Roth IRA, the final regulations, like the proposed regulations, provide that the period that the rolled-over funds were in the Roth Account does not count towards the 5-taxable-year period. However, if an individual had established a Roth IRA in a prior year, the 5-year period that began as a result of that earlier Roth IRA contribution applies to any distributions from the Roth IRA (including a distribution of an amount attributable to a rollover contribution from a Roth Account).

#### **Certain Amounts Not Qualified Distributions.**

The regulations clarify that certain amounts that are not treated as eligible rollover distributions under the Treasury Regulations are not eligible for Roth Contribution treatment (for example, as noted above, corrective distribution of pre-tax contributions in excess of various legal limits). However, other amounts are not precluded from being treated as a qualified distribution excludable from gross income merely because they are not eligible for rollover, including hardship distributions, required minimum distributions and payments in a stream of periodic payments.

#### **Roth Contributions as Excess Deferrals.**

The total amount of pre-tax contributions and Roth Contributions to a plan cannot exceed the Code Section 402(g) limit each year (i.e., \$15,500 for 2007), plus an additional amount in catch-up contributions for participants who are at least age 50 (i.e., \$5,000 for 2007). Amounts contributed in excess of this limit can be distributed by April 15th of the following year without adverse tax consequences. However, if the excess is not distributed by April 15th of the following year, any distribution attributable to a Roth Contribution is includible in gross income (with no exclusion from income for amounts attributable to basis) and is not eligible for rollover. The first amounts distributed from the Roth Account are treated as distributions of excess deferrals and earnings until the full amount of those excess deferrals (and attributable earnings) are distributed.

#### **Two Separate Plans.**

The balance of a participant's Roth Account and other accounts under the plan are treated as held under two separate plans for certain various purposes, including the automatic rollover rules. For example, if a participant has less than \$1,000 in his or her Roth Account and less than \$1,000 in other accounts, the plan will not need to provide the participant with the right to an automatic rollover even if the total benefit of the participant under the plan exceeds \$1,000.

#### **Reporting and Recordkeeping.**

The plan administrator (or other responsible party) is responsible for keeping track of the 5-taxable-year period for each employee and the amount of Roth Contributions made on behalf of the employee. In addition, the plan administrator of a plan directly rolling over a distribution is required to provide the

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plan administrator of the recipient plan with a statement indicating either the first year of the 5-taxable-year period for the employee and the portion of the distribution attributable to basis (i.e., the portion that is non-taxable if distributed before 5 years), or that the distribution is a qualified distribution. If the distribution is not a direct rollover, the plan administrator must provide the employee this same information upon request, except that the statement does not have to indicate the first year of the 5-taxable-year period. The statement is required to be provided within a reasonable period, but not later than 30 days, following the direct rollover (or employee request), and the plan administrator for the recipient plan is permitted to rely on these statements.

If a distributee indirectly rolls over any portion of a distribution that would be includible in income (without regard to the rollover), the plan administrator of the recipient plan must notify the IRS of its acceptance of the rollover contribution and the following information: (1) the employee's name and social security number; (2) the amount rolled over; (3) the year in which the rollover contribution was made; and (4) any other information required by the IRS. The IRS will release Forms and Instructions for this purpose, and until they are released, no reporting is required.

With respect to other reporting, generally, the same reporting requirements apply to plans with Roth Accounts as apply to plans without Roth Accounts. A contribution to and a distribution from a Roth Account must be reported on Form W-2 and Form 1099-R. An employee has no reporting obligation with respect to Roth Contributions. However, an employee rolling over a distribution from a Roth Account to a Roth IRA should keep track of the amount rolled over in accordance with the instructions to Form 8606, "Nondeductible IRAs."

#### **Other Issues.**

The final regulations clarify that catch-up contributions may be made as Roth Contributions. The final regulations also address the taxation of employer securities under the net unrealized appreciation rules and the distribution of an annuity contract in the context of Roth Accounts.

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#### **Client Alert**

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