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EMPLOYEE BENEFITS ALERT AUGUST 2005

PLANNING FOR THE ROTH 401(K)

The Internal Revenue Service recently issued proposed regulations for the new Roth contributions to 401(k) and 403(b) plans. Similar to Roth IRA contributions, Roth contributions to 401(k) and 403(b) plans will be made on an after-tax basis. When the Roth contributions are withdrawn, both the principal amount and earnings will come out tax-free provided certain requirements are met.

The effective date for sponsors wishing to incorporate a Roth program into their existing 401(k) or 403(b) plan is January 1, 2006.

Ever since their introduction by the Taxpayer Relief Act of 1997, Roth IRAs have been a popular means for taxpayers below certain income thresholds ($110,000 for single individuals, $160,000 for married individuals) to put aside after-tax dollars in their IRAs that can grow without being subject to tax again in the future. In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). EGTRRA included the addition of Internal Revenue Code (IRC) § 402A that provides for Roth IRA-style contributions to 401(k) plans, but without the restrictions that limit contributions to individuals with income below the Roth IRA compensation limits.

THE BASICS OF THE ROTH 401(K)

Contributions. The Roth 401(k) is designed to allow plan participants to make employee contributions to the plan on an after-tax basis, and for these contributions to grow with tax-free earnings and to be distributed at retirement without triggering any future income tax liability. The Roth contributions must be irrevocably designated as Roth contributions and established in a separate account that maintains separate recordkeeping from the other contribution sources available under the plan. In many respects, these Roth contributions will resemble pretax salary deferral under IRC § 401(k) inasmuch as an election to withhold them from salary must be made by the participant and they may only be distributed upon the occurrence of specific events. These designated Roth contributions will be aggregated with regular, pre-tax salary deferrals for purposes of the annual limitation on deferrals, which will be $15,000 for 2006 ($20,000 if the participant is eligible to make age 50 catch-up contributions).

Matching Contributions. The Roth 401(k) rules do not provide for employer after-tax matching contributions. Employer matching contributions on Roth 401(k) contributions will continue to be treated as pre-tax contributions subject to taxation when distributed to a participant.

Rollover Contributions. If a Roth 401(k) plan permits, a participant may make rollover contributions of his or her Roth 401(k) distributions from other tax-qualified plans.

Plan Documents. The proposed regulations indicate that Roth provisions will need to be reflected in the terms of the plan document but do not address precisely the way they should be reflected. This should be forthcoming in additional guidance.

Nondiscrimination Rules. Roth 401(k) contributions are aggregated with and treated as pre-tax elective deferrals under IRC § 401(k) for purposes of the ADP test under IRC § 401(k). When a plan needs to reduce contributions by HCEs, the plan will be able to either specify whether Roth 401(k) or pre-tax deferral contributions are returned first, or authorize plan participants to elect which contributions are refunded. If a Roth 401(k) contribution is refunded, only earnings on the Roth 401(k) contribution are subject to taxation.

Separate Accounting. A Roth 401(k) must maintain separate accounts for participant Roth 401(k) contributions, and must keep separate records for each Roth 401(k) account. Thus, plan recordkeepers will need to establish new Roth 401(k) sources on their recordkeeping systems.

Distributions. Because a participant's Roth 401(k) account will be treated as an elective deferral, it will be eligible for distribution, subject to the terms of the plan, only on a participant's termination of

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employment, death, disability, attainment of age $59\frac{1}{2}$, or hardship. The proposed regulations provide that Roth 401(k) accounts, unlike Roth IRAs, are subject to the IRC's minimum distribution requirements under IRC§401(a)(9). Further, in order to be treated as a tax-free distribution, a distribution from a Roth 401(k) account must be a "qualified distribution." In order to be treated as a "qualified distribution," the distribution: (1) must be made after a participant attains age $59\frac{1}{2}$, dies, or becomes disabled, and (2) may not be made within five years of the first Roth 401(k) contribution to the plan.

Rollover Distributions. A participant may roll over his or her Roth 401(k) account to another Roth 401(k) plan that accepts rollovers of a Roth IRA.

NEXT STEPS FOR EMPLOYERS AND RECORDKEEPERS

Many of our plan sponsor clients are receiving questions about the Roth 401(k) from plan participants and are being asked whether their plan will contain a Roth option. After a plan sponsor has made the decision to offer a Roth option, the plan sponsor should take several steps to implement the program in their defined contribution plan.

First, a plan sponsor will need to communicate with its recordkeeper as to the recordkeeper's ability to keep separate records for Roth 401(k) contributions. Additionally, the plan sponsor should review its own recordkeeping and payroll systems to determine whether any changes will be required. If the plan sponsor utilizes an outside payroll vendor, the plan sponsor should verify that a Roth program will not require changes to the plan sponsor's systems.

Second, after final IRS guidance is issued, a plan sponsor will need to begin preparation of plan amendments implementing Roth 401(k) features. New summary plan descriptions or summary of material modifications and election forms will also be required.

Finally, once the determination letter process is open to EGTRRA and Roth 401(k) features, a determination letter should be submitted for the plan.

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