Publications

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SERVICES

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Starting with plan years beginning in 2006, plan sponsors may offer their employees the ability to make after-tax 401(k) and 403(b) contributions where earnings are not usually taxed on distribution. These contributions are called "Roth contributions."

Roth contributions may be attractive to a wide range of employees. The income limits that make many highly-paid employees ineligible to make Roth IRA contributions do not apply to Roth contributions to 401(k) and 403(b) plans. At the same time, lower-paid employees who currently contribute to Roth IRAs may face lower administrative fees by making Roth contributions to 401(k) and 403(b) plans than by contributing to Roth IRAs. However, the benefits of Roth contributions do come with some drawbacks.

This article reviews the rules governing Roth contributions and potential issues facing plan sponsors and service providers who elect to implement Roth contributions.

A. Statutory Background

When Congress enacted EGTRRA, Roth contributions were added to the Code to allow 401(k) and 403(b) plan participants to make Roth-style, after-tax contributions to their plans that would grow without future earnings being subject to federal income tax liability. However, these provisions were adopted with an effective date of taxable years beginning on or after January 1, 2006. The statutory provisions governing Roth contributions are contained in Code section 402A.

The general rule under Code section 402A is that any contribution designated by a participant as a "designated Roth contribution" to a "qualified Roth contribution program" will be treated the same as an elective deferral for purposes of Code sections 401 and 403.[1]

A "designated Roth contribution" is a contribution that is designated as a Roth contribution by an employee and that, except for being subject to taxation as a Roth contribution, could be an elective deferral excluded from the employee's gross income.[2] Except for rollover contributions from other Roth accounts, Roth contributions are aggregated with non-Roth elective deferrals and subject to the elective deferral limits under Code section 402(g) ($15,000 in 2006 for 401(k) plans ($20,000 for Code section 414(v) catch-up eligible participants)).[3]

A "qualified Roth contribution program" must satisfy two basic requirements. First, a participant must be able to designate that some or all of his or her elective deferrals will be Roth contributions.[4] Second, Roth contributions must be tracked and record kept in a separate account with applicable earnings and losses allocated to the Roth account.[5]

For a distribution from a designated Roth account to be tax-free, it must be a "qualified distribution." In general, a "qualified distribution" is a distribution that is made after (1) a participant reaching age 59, a participant's death, or a participant becoming disabled and (2) that is not made within five years of a participant's first Roth contribution to the applicable plan or a predecessor plan to which Roth contributions were also made.[6] If Roth contributions result in excess deferrals under Code section 402(g), the excess deferrals may be distributed by April 15 of the year following the year of contribution without being subject to taxation even though the distribution is not a qualified distribution.[7]

Lastly, distributions from Roth accounts will not be aggregated with distributions from non-Roth accounts for Code section 72 purposes.[8]

B. Proposed Regulations

On March 2, 2005, the IRS issued proposed regulations providing guidance on Roth contributions.[9] Although the Code's Roth contribution provisions are contained in Code section 402A, the proposed regulations are written as additional language that is intended to supplement the recently issued comprehensive final regulations under Code sections 401(k) and 401(m).[10] As is the case with Code section 402A, the proposed regulations would apply to plan years beginning on or after January 1, 2006.

The proposed regulations provide as follows:

- *Contribution Elections*. The proposed regulations add two additional requirements to the Code section 402A(c)(1) definition of a "designated Roth contribution":
  - The proposed regulations require that an employee irrevocably designate his or her contributions as Roth contributions at the time of his or her cash or deferred election.[11]
  - The proposed regulations require that Roth contributions be included in income and subjected to withholding at the time the employee would have contributed such amounts.[12] Presumably, this rule apparently prevents plan sponsors with non-calendar year plans from taxing Roth contributions at the end of a plan year, rather than when they are actually contributed to a plan.
- *Separate Accounting*. The proposed regulations add guidance on the Code section 402A(b)(2) separate accounting requirement. Under this guidance, Roth contributions, earnings, and distributions must be tracked in a separate account. Gains, losses, and other credits or charges must be allocated to a Roth account and other plan accounts on a reasonable and consistent basis. This rule works to prevent the allocation of only gains to a non-taxable Roth account while allocating costs and expenses to a taxable account. Forfeitures may not be allocated to a Roth account. The separate accounting requirement applies so long as a Roth account exists.[13]
- *Compliance With Elective Deferral Requirements***.** The proposed regulations provide that Roth contributions must satisfy the requirements applicable to elective contributions made under a cash or deferred arrangement.[14] As such, Roth contributions must be nonforfeitable, must follow the distribution-timing rules applicable to pre-tax elective deferral contributions, and are treated as elective deferral contributions for most purposes (including nondiscrimination testing under Code sections 401(k) and (m)). Notably, Roth accounts, unlike Roth IRAs, are subject to the minimum required distribution rules during a participant's lifetime (e.g., at the later of age 70_ or retirement).
- *401(k) and (m) Nondiscrimination Testing*. The proposed regulations provide that a plan may permit an employee to designate whether excess contributions (as determined after ADP and ACP testing) are attributable to his or her pre-tax or Roth contributions.[15] If a Roth contribution is distributed as an excess contribution, only income on the distributed Roth contribution is subject to tax. However, this income is subject to the "gap period" income rules set forth in the final 401(k) regulations.[16]

C. Plan Drafting Guidance

The preamble to the proposed regulations and other IRS guidance provides that plan amendments will be necessary to implement a Roth contribution feature.[17] For example, it will be necessary to provide the extent, if any, to which an employee can choose whether his or her distribution from a plan is attributable to his or her pre-tax and Roth contributions. The preamble also indicates that it also will be necessary to update a plan's rollover distribution language to incorporate the eligible rollover distribution rules applicable to Roth accounts.

For plan sponsors wishing to get an early start on drafting, the IRS issued revised listings of required modifications ("LRMs") in March 2005 for master and prototype defined contribution and 401(k) plans.[18] These LRMs provide model language addressing the following:

- The definition of "Roth contributions."[19]
- The inclusion of Roth contributions in "eligible rollover distributions".[20]
- A participant's ability to designate some or all of his or her deferrals as Roth contributions.[21]
- The nonforfeitability and separate accounting requirements applicable to Roth contributions.[22]

However, sponsors should note that the LRMs will be amended to reflect any changes made by final Roth contribution regulations. The changes will need to be incorporated in master and prototype plans submitted for an opinion letter under the EGTRRA master and prototype program.[23]

D. Unresolved Questions

Despite the simplicity of the Roth contribution statutory provisions and regulatory guidance, a number of questions remain to be addressed, including the following:

- *Mandatory Roth Contributions*. Code section 402A(b)(1) and the proposed regulations appear to require that a participant must be afforded the opportunity to elect between Roth and elective deferral contributions. As such, it may not be possible to offer a Roth contribution-only plan. Further, it is not clear whether automatic enrollment providing for Roth contributions is permitted.
- *Tracking of Rolled-Over Roth Contributions*. Code section 402A(d)(2)(B) provides that a Roth contribution may not be distributed tax-free if it is distributed within five years of a participant's first Roth contribution to the plan or a predecessor plan to which Roth contributions were also made. However, the proposed regulations do not address whether a plan may rely on participant representations regarding the date on which Roth contributions were first made to a predecessor plan for purposes of applying the five-year holding requirement or whether and what substantiation of such a representation will be required.
- *Rollovers from Roth IRAs into Plan with Roth Contributions*. Code section 402A(c)(3) provides rules governing the contribution of rolled-over Roth contributions. However, it is not clear whether a participant may roll amounts from a Roth IRA into a qualified plan with Roth contributions. Allowing these rollovers would (1) require tracking of the five-year aging requirement, (2) require rules governing the substantiation of when Roth contributions were first made, and (3) require rules governing the substantiation of the eligibility of the rollover contribution (as is currently the case with pre-tax rollover contributions).[24]
- *Taxation of Non-Qualifying Distributions*. Roth accounts that are distributed for a reason other than a "qualifying distribution" will be subject to income taxation. The proposed regulations are silent as to whether non-qualifying distributions may be treated as a return of basis (as is the case with traditional after-tax contributions).
- *Loans*. Presumably, because Roth contributions are treated as elective deferrals, Roth accounts may be used to fund participant loans under Code section 72(p). If, however, a participant fails to repay his or her loan, it is not clear how the deemed distribution and loan default rules will apply to amounts withdrawn from Roth accounts. For example, it appears that the "deemed distribution" of Roth contributions will trigger taxation unless the "deemed distribution" qualifies as a part of a "qualified distribution" under Code section 402A(d)(2)(C). Furthermore, as noted above, it is not clear whether non-qualifying distributions of Roth contributions may be treated as a return of after-tax contributions (and thus return of basis rules would apply).
- *Model Amendments*. The IRS has not stated whether it intends to publish a model or sample amendment or when individually designed plans must be amended if this feature is added in before the end of their EGTRRA remedial amendment period.

- *Payroll Withholding Issues***.** Plans that currently permit participants to elect to defer a large percentage of their compensation (*e.g.*, up to 70% of compensation) may need to revisit these contribution limits to ensure that enough of a participant's paycheck is available to satisfy the federal and state tax withholding requirements that will apply to Roth contributions (*e.g.*, federal withholding rates between 10% and 35% of gross income and FICA).
- *Automatic Rollover Rules*. Effective March 28, 2005, mandatory cashouts of amounts between $1,000 and $5,000 became subject to the mandatory rollover rules in Code section 401(a)(31).[25] Because Roth contributions are treated as elective deferrals, Roth accounts may be subject to the mandatory rollover rules. As such, plans providing for mandatory cashouts of amounts between $1,000 and $5,000 may need to work with their service providers to provide default rollover Roth IRA accounts for Roth contributions.
- *403(b) Plans*. The proposed 403(b) regulations do not address Roth contributions. Presumably the final 403(b) regulations or other subsequent guidance will address Roth 403(b) contributions.[26]

E. Design Considerations

Many plan sponsors and service providers have begun considering and preparing for the implementation of Roth contributions. Informal studies have indicated that at least 1/3 of employers are interested in adding Roth contributions to their plans.

If a plan sponsor or service provider is considering adding or supporting Roth contributions, additional issues to consider include the following:

- *Pension Simplification Proposals*. The Bush administration has proposed simplifying the myriad of 401(k), 403(b) and 457(b) rules into a simple program called an "employer retirement savings account" ("ERSA"). As proposed, ERSAs would be funded by Roth-style after tax contributions. If ERSAs are enacted, plan sponsors might need to transition their Roth contribution accounts (and traditional elective deferral accounts) to an ERSA structure.
- *Sunset After December 31, 2010*. As is the case with many Code provisions added by EGTRRA, Roth contributions are due to sunset after December 31, 2010.[27] It is expected that Roth contributions will result in a long-term reduction in revenue received by the Treasury due to the tax-free distribution of Roth accounts. As such, it is unclear whether there is sufficient political support for enacting legislation permitting Roth contributions after 2010.
- *Representative Cardin's Legislation*. On April 28, 2005, Representative Cardin introduced the Pension Preservation and Savings Expansion Act. The Act would repeal Code section 402A prior to its January 1, 2006, effective date.
- *Effect of Open Issues*. A number of the unresolved questions described above may create administrative complexity and burdens for plan sponsors and service providers. For example, depending on the guidance issued by the IRS on loans, plan sponsors and their recordkeepers may need to program their systems to (1) track basis in Roth contributions, (2) determine whether deemed distributions are "qualified distributions" under Code section 402A(d)(2), and (3) address the hierarchy of withdrawals for loans.
- *Administrative Costs*. Compliance with the separate recordkeeping requirements in Code section 402A(b)(2) and the proposed regulations, the potential need for enhanced participant communications, and the need to automatically roll over small-sum Roth accounts to Roth IRAs may each add additional costs for plan sponsors and service providers.
- *Correction of Failures*. Unless an updated version of the EPCRS self-correction program allows for the self-correction of pre-tax contributions incorrectly treated as Roth contributions (or vice versa), this failure may add correction costs for plan sponsors.
- *Communication with Participants*. If a plan permits Roth contributions, participants are likely to ask whether they should elect to make pre-tax elective deferrals or Roth contributions. Although some plans are already providing investment advice to participants, advice on whether to make Roth or elective deferral contributions could create new fiduciary exposure for plan sponsors and administrators. Further, because whether Roth contributions are appropriate to an individual may depend on many factors (including, but not limited to, a participant's age, current income, projected non-Roth retirement income, and expectations regarding future tax rates), it may be difficult to advise participants regarding the appropriate savings vehicle. Thus, there is potential for participant confusion if Roth contributions are introduced.

F. Conclusion

Roth contributions to 401(k) and 403(b) plans are likely to be attractive to many participants in employer-sponsored 401(k) and 403(b) plans. However, plan sponsors and service providers considering whether to implement Roth contributions should tread carefully, as there are a number of legal and administrative issues that could add confusion, expense, or legal exposure for plan sponsors, their employees, and service providers.

[1] Code section 402A(a).

[2] Code section 402A(c)(1).

[3] Code sections 402A(c)(2) and (3).

[4] Code section 402A(b)(1).

[5] Code section 402A(b)(2).

[6] Code section 402A(d)(2).

[7] Code section 402A(d)(3).

[8] Code section 402A(d)(4).

[9] 70 Fed. Reg. 10062 (Mar. 2, 2005).

[10] Treasury Decision 9169, 69 Fed. Reg. 78143 (Dec. 29, 2004).

[11] Prop. Treas. Reg. ¤ 1.401(k)-1(f)(1)(i).

[12] Prop. Treas. Reg. ¤ 1.401(k)-1(f)(1)(ii).

[13] Prop. Treas. Reg. ¤ 1.401(k)-1(f)(2).

[14] Prop. Treas. Reg. ¤ 1.401(k)-1(f)(3).

[15] Prop. Treas. Reg. ¤¤ 1.401(k)-2(b)(1)(ii) and 1.401(m)-2(b)(2)(vi)(C).

[16] Treas. Reg. ¤¤ 1.401(k)-2(b)(2)(iv) and 1.401(m)-2(b)(2)(iv).

[17] Notice 2004-84, I.R.B. 2004-52 (Dec. 14, 2004) and Announcement 2004-71, I.R.B. 2004-40 (September 13, 2004).

[18] http://www.irs.gov/retirement/article/0,,id=97182,00.html

[19] CODA LRMs, Item (V).

[20] Defined Contribution LRMs, Item 51.

[21] CODA LRMs, Item (III).

[22] CODA LRMs, Item (XV).

[23] Revenue Procedure 2005-16, I.RB. 2005-10 (Feb. 17, 2005).

[24] Treas. Reg. ¤ 1.401(a)(31)-1, Q&A 14.

[25] Notice 2005-5, I.R.B. 2005-3 (December 28, 2004).

[26] 69 Fed. Reg. 67075 (Nov. 16, 2004).

[27] P.L. 107-16 ¤ 901.