

## **Coming Soon . . . The Roth 401(k)**

*By David N. Levine<sup>1</sup>*

The 401(k) plan is the most popular type of employer-sponsored retirement plan. The Bush administration has proposed replacing the myriad of individual account retirement plans – 401(k)s, 403(b)s, and 457(b)s – with a single type of individual savings account – the employer retirement savings account. The ERSA would be an after-tax, Roth IRA-style account, where participants could elect to contribute up to \$15,000 year on an after-tax basis. All contributions would grow with earnings and could be distributed at a later date without being subject to any further federal income tax. However, what is often overlooked is that the tax Code is already scheduled to provide an ERSA-style account as of January 1, 2006. This January 1, 2006, account is the Roth 401(k) account.<sup>2</sup>

### **Part I: The Benefits of a Roth 401(k)**

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 be subject to tax again in the future. In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act. EGTRRA included a sweeping set of changes to the rules governing pension plans, 401(k) plans, and other defined contribution plans. Included in these changes was the addition of a new section of the Internal Revenue Code – section 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 IRA compensation limits.

Employees at many income levels will benefit from Roth 401(k) accounts.

Lower income employees are currently eligible to contribute to Roth IRAs. However, the maximum amount that these employees can contribute is very limited (\$4,000 (\$4,500 for employees over age 50) in 2005). In addition, many Roth IRA service providers impose small account fees on small Roth IRAs that can chip away a Roth IRA's value. However, in a Roth 401(k) plan, plan administration fees may be paid by a plan or plan sponsor, thus allowing participant contributions to grow without reduction for administrative overhead costs.

Higher income employees have not had the ability to use Roth IRAs because of the Roth IRA income limits. Although many plans already permit employees to make after-tax contributions to 401(k) plans, earnings on these after-tax contributions are subject to federal income taxation when they are distributed. However, by adopting Roth

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<sup>2</sup> The Roth 401(k) rules will also apply to employee contributions to tax-sheltered annuity 403(b) plans. As such, employers eligible to establish a 403(b) plan will be able to create a Roth 403(b) plan as of January 1, 2006. Roth 457(b) and 501(c)(18) plans will not be permitted.

401(k)s these highly compensated employees will be able to save up to \$15,000 per year (in 2006, subject to an inflation adjustment in future years) without future income tax liability on the earnings on these Roth 401(k) contributions.

Further, there is one significant benefit to both lower income and higher income employees –contributions to a Roth 401(k), unlike Roth IRAs, may be matched by a participant's employer on a pre-tax basis.

## **Part II: The Basics of the Roth 401(k)**

The Roth 401(k) is designed to allow 401(k) plan participants to make their contributions to the plan on an after-tax basis, for these contributions to grow with tax-free earnings, and to be distributed at retirement without triggering any future income tax liability.

There are several specific rules governing a Roth 401(k) plan.

*Designation of Elective Deferrals as Roth 401(k) Contributions.* In creating the Roth 401(k), Congress established a basic rule that a Roth 401(k) contribution will, for most purposes, be treated the same as an elective deferral. Code section 402A(a)(1). Although not specifically stated in the Code, the EGTRRA committee reports indicates that a participant must designate his or her 401(k) contributions as Roth 401(k) contributions prior to the date they are contributed to a plan. Regulations proposed on March 2, 2005, provide that a Roth contribution is an elective contribution that (1) is designated at the time of the contribution election as a Roth contribution, (2) is treated by an employer as income to the employee at the time of contribution, and (3) is maintained by a plan in a separate account. Prop. Treas. Reg. § 1.401(k)-1(f)(1).

Because Roth 401(k) contributions are treated as elective deferrals, Roth 401(k) contributions are subject to the \$15,000 maximum deferral limit in 2006 when Roth 401(k)s will first be permitted under Code section 402(g) (\$20,000 if a participant is eligible to make age 50 catch-up contributions under Code section 414(v)). Furthermore, if a participant makes both Roth 401(k) contributions and pre-tax elective deferral contributions, the two contributions may not exceed the Code section 402(g) limit. Code section 402A(c)(2).

*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. Like regular rollover contributions, Roth 401(k) rollover contributions do not count against the Code section 402(g) \$15,000 elective deferral limit (in 2006 when Roth 401(k)s will first be permitted). Code section 402A(c)(3).

*Nondiscrimination Rules.* Roth 401(k) contributions are aggregated with and treated as elective deferrals for purposes of the actual deferral percentage test under Code section 401(k). Although they are after-tax contributions, Roth 401(k) contributions are not included with traditional after-tax contributions and, accordingly, are not generally subject to the actual contribution percentage test under Code section 401(m).

When a plan needs to reduce contributions by highly compensated employees, 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 on a participant-by-participant basis. If a Roth 401(k) contribution is refunded, only earnings on the Roth 401(k) contribution are subject to taxation. Prop. Treas. Reg. §§ 1.401(k)-2(b)(2)(vi)(C) and 1.401(m)-2(b)(2)(vi)(C).

Also, recently issued final 401(k) regulations provide that a Roth 401(k) contribution feature will be treated as a benefit, right, or feature that is subject to the nondiscrimination testing rules under Code section 401(a)(4). Treas. Reg. § 1.401(k)-1(a)(4)(iv)(B).

*Separate Accounting.* A Roth 401(k) must maintain separate accounts for participant Roth 401(k) contributions and must separately recordkeep each Roth 401(k) account. As such, Plan recordkeepers will need to establish new Roth 401(k) sources on their recordkeeping systems. Further, Roth 401(k) accounts and non-Roth accounts will need to be charged and credited with gains, losses, and other credits and charges on a reasonable basis. Prop. Treas. Reg. § 1.401(k)-1(f)(2). Presumably, this rule is intended to prevent the disproportionate allocation of expenses and losses to tax-deferred accounts in order to maximize the value of non-taxable Roth accounts.

*Distributions.* Because a participant's Roth 401(k) account will be treated as an elective deferral it will only be eligible for distribution on a participant's termination of employment, death, disability, attainment of age 59½ (if permitted under the terms of the plan), or hardship. Further, the proposed regulations provide that Roth accounts, unlike Roth IRAs, are subject to the Code section 401(a)(9) minimum required distribution during a participant's lifetime. Prop. Treas. Reg. § 1.401(k)-1(f)(3).

However, a participant's reaching one of these distribution events will not necessarily ensure tax-free treatment of distributions of his or her Roth 401(k) account. 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 must be made after (1) a participant's reaching age 59½, a participant's death, or a participant becoming disabled and (2) may not be made within five years of the first Roth 401(k) contribution to the plan or a predecessor Roth 401(k) plan. Code section 402A(d)(2). Unlike a Roth IRA, however, a distribution from a Roth 401(k) to finance the first time purchase of a home will not be treated as a "qualified distribution."

Plan sponsors will also need to decide how Roth 401(k) distributions fit into their plan distribution hierarchies (*e.g.*, participant distributions are first from pre-tax deferrals, then from Roth 401(k) contributions, then from rollover accounts, etc.). The preamble to

the proposed Roth contribution regulations indicates that this hierarchy will need to be incorporated in plan documents.

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

*Excess Deferrals.* If a participant contributes pre-tax and Roth 401(k) contributions to one or more defined contribution plans in an amount in excess of the Code section 402(g) limit (e.g., \$15,000 in 2006 when Roth 401(k)s will first be permitted) this excess must be distributed. Roth 401(k) contributions that are distributed as excess deferrals on or before April 15 of the year following the year of contribution will not be subject to additional taxation because, at the time they are taxed when contributed. However, earnings attributable to these excess Roth 401(k) contributions will be taxed when distributed.

If a plan fails to distribute excess Roth 401(k) contributions by the April 15 deadline, the Roth 401(k) contributions will be subject to double taxation – at the time they were first contributed and at the time of later distribution. In addition, earnings on these excess Roth 401(k) contributions will not be treated as after-tax and will be subject to taxation when distributed.

*Participant and Plan Level Reporting.* Roth 401(k) plans will need to report Roth 401(k) contributions as elective deferral contributions on a participant's Form W-2. Roth 401(k) distributions will need to be reported on Form 1099-R. IRS guidance will provide further information on complying with these requirements.

*Roth 401(k) Contributions and Safe Harbor Plans.* Presumably Roth 401(k) contributions will need to be taken into account when applying the Code section 401(k) and 401(m) safe harbor plan rules.

### **Part III: Open Issues**

The proposed regulations do not provide specific guidance on the taxation of the distribution of Roth contributions. The IRS is requesting comments on distribution issues and any other Roth contribution issues where guidance is needed.

Issues that will hopefully be addressed by additional IRS guidance include the following:

*Tracking of Five Year Aging for Roth 401(k) Account Rollovers.* The Roth 401(k) rules provide that a distribution from a Roth 401(k) account will not be a "qualified distribution" if it is distributed within five years of a participant's commencement of Roth 401(k) contributions to a plan. A special rule provides that, where a participant has rolled amounts into a Roth 401(k) account, the five year period begins to run as of the date that Roth 401(k) contributions were first made to the prior plan. Code section 402A(d)(2)(B)(ii). There is a parallel 5-year aging requirement for Roth IRAs. Code section 408A(d)(2)(B).

Hopefully the IRS will provide guidance that, much like the rules governing the determination of the validity of rollover contributions, allows plan administrators to rely on participant representations as to when prior plan Roth 401(k) contributions first commenced and that clarifies how the five year aging rules for Roth 401(k) and Roth IRA relate to each other.

*Minimum Required Distribution Rules.* Roth IRAs are not subject to the Code section 401(a)(9) minimum required distribution rules while the Roth IRA owner is living. Code section 408A(c)(5). However, the proposed regulations provide that Roth 401(k) contributions are treated as elective deferrals for most Code purposes and are subject to the minimum required distribution rules while a participant is alive. Prop. Treas. Reg. § 1.401(k)-1(f)(3). As such, it may be possible for a participant in a Roth 401(k) plan to roll over his or her Roth 401(k) account to a Roth IRA to avoid minimum required distributions during his lifetime.

*Model Amendments and the Determination Letter Process.* The preamble to the proposed regulations indicates that amendments to reflect plan practice and the eligible rollover distribution rules applicable to Roth accounts will need to be incorporated in plan documents. It is not clear, however, whether model amendments will be necessary or whether amendments will only need to be adopted by the end of a plan's EGTRRA remedial amendment period.

#### **Part IV: Next Steps for Employers and Recordkeepers**

Plan sponsors will have to take several steps to implement Roth 401(k) programs in their defined contribution plans.

First, a plan sponsor will need to communicate with its recordkeeper regarding its ability to separately recordkeep Roth 401(k) contributions. The sponsor may also need to modify its own recordkeeping and payroll systems.

Second, a plan sponsor will want to determine what and when Roth 401(k) features will be implemented in its defined contribution plan.

Third, after final IRS guidance is issued, a plan sponsor will need to begin preparation of plan amendments implementing Roth 401(k) features. The timing of these amendments may vary depending on whether future IRS guidance requires model amendments.

Fourth, once the Roth 401(k) program goes live, new election forms and communications (including new summary plan descriptions) will need to be provided to participants.

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