

January 31, 2006

MEMORANDUM TO CLIENTS

Comprehensive IRS Guidance on Roth 401(k) and 403(b) Plans

The IRS recently issued proposed and final regulations that provide guidance on the requirements applicable to Roth contributions under Code section 402A. 71 Fed. Reg. 6 (Jan. 3, 2006) and 71 Fed. Reg. 4320 (Jan. 26, 2006). The final regulations provide guidance on the requirements applicable to Roth contributions to 401(k) plans. The proposed regulations provide guidance on the taxation of distributions from Roth accounts, Roth account recordkeeping and reporting requirements, and Roth contributions to 403(b) plans.

The final regulations apply on and after January 1, 2006. The general effective date of the proposed regulations would be January 1, 2007, although a number of provisions would apply as of January 1, 2006. Taxpayers may rely on the proposed regulations until final regulations go into effect. Comments on the proposed regulations should be submitted by April 26.

A. Summary of Key Changes and Clarifications in the Final Regulations

The final regulations are generally consistent with the proposed Roth 401(k) regulations that were issued last March. Key changes and clarifications include the following:

- **Roth-Only Contribution Arrangements.** An employer may not offer a Roth 401(k)-only plan. If a Roth 401(k) plan is to be offered, pre-tax elective deferrals must also be permitted.
- **Timing of Roth Election.** Roth contributions must be irrevocably elected as part of a participant's cash or deferred election, not at a later date; retroactive recharacterization is not permitted. (This is probably a blessing for plan administrators and payroll personnel.)
- **Ability to Change Roth 401(k) Contribution Election.** Consistent with the final 401(k) regulations, a participant must be permitted to change his or her Roth 401(k) contribution election as to future contributions at least once per year.

- **Catch-Up Contributions.** Catch-up contributions may be made as Roth contributions.
- **Automatic Enrollment.** Individuals who become participants in a 401(k) plan because of an automatic enrollment feature may be automatically enrolled with Roth rather than pre-tax 401(k) contributions. A plan document must specify whether contributions made for automatically enrolled participants will be Roth or pre-tax elective deferral contributions.
- **Small Roth 401(k) Accounts.** A plan may provide that accounts of \$200 or less may not be rolled over in a direct rollover (plan-to-plan or IRA). Amounts held in Roth 401(k) accounts may be treated as a separate plan for purposes of applying this \$200 de minimis rule.
- **401(k) and 401(m) Nondiscrimination Testing.** A plan may, but is not required to, permit a participant to elect whether his or her Roth 401(k) or pre-tax elective deferral contributions will be refunded to satisfy the Code section 401(k) and 401(m) nondiscrimination tests. If a Roth 401(k) contribution is distributed as an excess contribution, only income on the distributed Roth contribution is subject to tax.

B. The Proposed Regulations

The proposed regulations provide guidance on the taxation of distributions from Roth accounts, Roth account recordkeeping and reporting requirements, and Roth contributions to 403(b) plans. In general, the regulations treat Roth amounts like other qualified plan funds whenever the statute does not preclude that. They also take a fairly restrictive approach on rollovers. Significant issues addressed by the proposed regulations are highlighted below.

1. Qualified Distributions

- **Definition of "Qualified Distribution."** "Qualified distributions" of Roth contributions and earnings are tax-free. A "qualified distribution" is a distribution made after the 5-taxable year participation period has been met, and that is made on account of a participant's attaining age 59½, death, or becoming disabled (as defined in Code section 72(m)(7)). The proposed regulations provide that distributions of amounts in excess of the Code section 402(g) limit (\$15,000 in 2006), amounts in excess of the Code section 415(c) limit (\$44,000 in 2006), distributions necessary to pass nondiscrimination testing, deemed distributions due to loan defaults or

Table 2001 insurance costs, and ESOP dividends paid in cash to participants under Code section 404(k) are not qualified distributions. The IRS notes that ESOP dividends reinvested in employer securities and subsequently distributed from Roth accounts in otherwise qualified distributions may be tax-free.

- **Calculation of Roth Account Five-Year Participation Period.** A distribution from a Roth account will not be tax-free if it is made within five years of a participant's first contribution to his or her Roth account. This five-year participation period is calculated as starting on the first day of a participant's tax year (generally the calendar year) in which a Roth contribution is made to the plan and ends after the completion of five tax years. Notably, a five-year participation period is determined separately for each plan in which a person participates. If a Roth account is directly rolled into a plan from another Roth 401(k) or 403(b) program, the five-year participation period for amounts in the recipient plan is treated as commencing as of the earlier of (1) the first Roth contribution to the transferor plan or (2) the first Roth contribution to the recipient plan.
- **Calculation of Roth IRA Five-Year Participation Period.** The five-year participation period for Roth accounts has no impact on the five-year participation period applicable to Roth IRAs. Instead, amounts rolled into a Roth IRA are subject to a separate five-year Roth IRA participation period. If a Roth account is rolled into an existing Roth IRA, the five-year Roth IRA participation period for all amounts in the Roth IRA, including the rollover contribution, will be based on the date of the first contribution to the Roth IRA. This provision would be effective as of January 1, 2006.

2. Restrictions on Roth Rollovers

Numerous restrictions apply to rollovers to and from Roth IRAs, Roth 401(k) and 403(b) accounts.

- The portion of a Roth account that is not subject to taxation on distribution (i.e., a participant's Roth contributions, and, if the five-year participation period is satisfied, the earnings on these contributions) may only be rolled over to a Roth IRA or to a Roth account under the same type of plan that agrees to separately account for Roth contributions and earnings (e.g., 401(k) to 401(k)). Non-taxable Roth 401(k)-to-Roth 401(k) and Roth 403(b)-to-Roth 403(b) rollovers must be made by direct rollover. However,

the non-taxable portion of a Roth account may be rolled to a Roth IRA by direct or indirect (60-day) rollover.

- The portion of a Roth account that is subject to taxation on distribution (*i.e.*, a distribution that is not a qualified distribution and is not a return of basis) may be rolled over to another eligible plan or Roth IRA by direct or indirect (60-day) rollover.
- A Roth IRA may not be rolled into a Roth 401(k) or 403(b) account.

3. Basis in Roth Accounts and Roth IRA Rollovers

Amounts contributed to a Roth account are treated as "basis" in the Roth account. A number of special rules apply when determining basis.

- Non-qualified distributions from a Roth IRA are treated as a tax-free return of basis up to the amount of Roth contributions. However, non-qualified distributions from a Roth account (*i.e.*, distributions made within five years of the initial contribution to the Roth account, or distributions not made on account of disability, attainment of age 59-1/2 or death) are treated like other plan distributions, *i.e.*, as a pro-rata return of non-taxable basis and taxable earnings, under the Code section 72 rules
- If only a portion of a non-qualified distribution is rolled over, the amount rolled over is first deemed to be from the taxable portion of the distribution, then from basis. This permits an owner to roll over only the otherwise taxable portion.
- If a qualified distribution from a Roth account is rolled into a Roth IRA, a participant's basis in his or her Roth IRA is increased by the value of the entire distribution (in effect giving the participant the full benefit of Roth treatment).
- If a non-qualified distribution of a Roth account is rolled into a Roth IRA, a participant's basis in his or her Roth IRA is increased by the participant's basis in the Roth account distribution.
- If rolled-in amounts are distributed from a Roth IRA prior to satisfaction of the Roth IRA five-year participation period, the original rollover contribution to the Roth IRA (but not the earnings) would be treated as a return of basis from the Roth IRA.

- These basis calculation rules would generally apply as of January 1, 2006.
- Each plan must track the five-year holding periods for Roth contributions to the plan and the amount of each participant's Roth contributions. When a plan makes a direct rollover, it is required to provide a rollover statement to the recipient. If the distribution is a qualified distribution, the statement must indicate that it is a qualified distribution. If the distribution is not a qualified distribution, the statement must provide the year of the first Roth contribution to the plan and the portion of the rolled-over distribution attributable to basis. A participant making an indirect (60-day) rollover may request a similar rollover statement, although the first year of the Roth account five-year participation period need not be provided in the statement. A required rollover statement must be provided within 30 days of a request or the direct rollover.

4. **Other Distribution Issues**

- **Hardship Distributions.** Roth contributions – but not earnings on these contributions – are available for hardship distributions. (This is the same treatment as 401(k) elective deferrals.) Nevertheless, when distributed in a hardship distribution, Roth contributions are treated as a pro rata return of basis and earnings, so the earnings portion of the hardship payout is taxed and the basis is not.
- **Separate Contracts/Loans.** All of the participant's Roth and non-Roth accounts are combined for purposes of applying the plan loan rules (e.g., 50% of vested accrued benefit limit, \$50,000 loan limit, etc.). Otherwise, a participant's Roth account is considered a single "separate contract" from any other plan account (e.g., 401(k) rollover) for the participant, i.e., distributions from each contract are subject to the section 72 rules independently (with limited exceptions for certain QDROs and post-death beneficiary accounts). A regular Roth account and a rollover Roth account for the same participant in the same plan are aggregated as a single contract.
- **Distribution of Excess Deferrals.** If a participant makes deferrals (including Roth contributions) in excess of the Code section 402(g) limit (\$15,000 in 2006), he or she may designate whether the excess will be paid out of his or her pre-tax or Roth contributions. Further, distributions of excess contributions (Code sec. 402(g)) are subject to the "gap period" income calculation rules in the new Code section 401(k) and 401(m)

regulations. If excess Roth contributions are not distributed by April 15th of the tax year following their contribution, the excess Roth contributions are not eligible for rollover, and will be taxed again on distribution (i.e., not treated as a return of basis); also, the first distributions out of the Roth account will be attributed to the participant's excess Roth contributions and earnings on these contributions.

- **Distribution of Employer Securities**. A participant who receives a qualified distribution of employer securities with net unrealized appreciation will have basis in the securities equal to the fair market value of the securities as of the date of distribution; thus, only future appreciation will be subject to tax at capital gains rates. The Preamble indicates that a distribution that is not a qualified distribution will be subject to the regular net unrealized appreciation rules under Code section 402(e)(4) except that the Roth account is treated as a separate contract.

5. **Reporting and Recordkeeping Issues**

- **Information Reporting of Indirect Plan-to-Plan Rollovers**. Each plan accepting an indirect rollover must report the following to the IRS by the due date for filing Form 1099-R: (1) a participant's name and social security number, (2) the amount rolled over, (3) the year in which the rollover contribution was made, and (4) such other information as may be required by the IRS in later guidance.
- **Form W-2 and 1099-R Reporting**. The 2006 Form W-2 contains two new codes for Box 12 of Form W-2 – one for Roth contributions to 401(k) plans and one for Roth contributions to 403(b) plans. Plan sponsors will also likely need to report Roth distributions on a separate form 1099-R. The separate Form 1099-R will list the amount of a distribution, the taxable amount of the distribution, and the first year of the five-year holding period.
- **Tracking Basis in Roth IRAs**. The proposed regulations recommend that participants who roll their Roth accounts to a Roth IRA track their basis to facilitate the reporting of their Roth IRA distributions on Form 8606 when they receive a distribution from their Roth IRA.
- **"Anti-Abuse" Provision**. Consistent with the final regulations, any transaction or accounting methodology that has the effect of directly or indirectly transferring value from another account into the designate Roth

account violates the Roth separate accounting requirement. This provision would be effective as of January 1, 2006.

6. Roth 403(b) Plans

In general, the rules governing Roth contributions to 401(k) plans apply to contributions to Roth 403(b) plans. Thus, for example, special catch-up and other 403(b) rules apply equally to Roth 403(b)s. IRS notes that the basis recovery rules for annuity distributions will apply separately to payouts from Roth and regular 403(b) accounts. The proposed rules clarify that the right to make Roth contributions to a 403(b) plan must be universally available to satisfy the Code section 403(b)(12) universal availability requirement.

The Preamble reflects an expectation that the final 403(b) rules (currently expected in mid-2006) will also be effective for 2007 plan years.

C. Plan Amendments

Plan sponsors that implement Roth contributions in 2006 must amend their plans as required by the guidance in Revenue Procedure 2005-66 and the IRS cumulative list of changes in Notice 2005-101. In general, this means that amendments to calendar-year plans should be made by December 31, 2006, because the addition of Roth contributions appears to be a discretionary plan amendment. Plan sponsors whose plans are not subject to the final 401(k) regulations as of January 1, 2006 (e.g., fiscal year plans), need not adopt the final 401(k) regulations early in order to apply the Roth 401(k) regulations on or after January 1, 2006.

Although the IRS has not provided model language on implementing Roth contributions other than basic language in its Listing of Required Modifications for defined contribution and 401(k) plans (<http://www.irs.gov/retirement/article/0,,id=97182,00.html>), the proposed and final regulations indicate that amendments covering Roth contributions should at least address the following:

- 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;
- whether excess deferrals will be distributed out of pre-tax, Roth, or a combination of the two accounts and whether this hierarchy will be elected each participant or established in the plan document;

- the rollover of Roth contributions into and from the plan;
- whether automatically enrolled participants are deemed to have elected Roth or pre-tax contributions;

Final regulations and/or additional IRS guidance may require the incorporation of additional Roth-specific distribution rules, such as the implementation of mandatory rollovers to Roth IRAs, in plan documents.

D. Additional Administration and Communication Issues

There are many administration and communication issues for plan sponsors that have already adopted or intend to implement Roth contributions in 2006, including the following –

- Plan sponsors who implemented Roth contributions as of January 1 should review the final regulations and new proposed regulations to ensure that their implementation is consistent with the final regulations and new proposed regulations.
- Because pre-tax elective deferrals generally may not be refunded or recharacterized once contributed, plan sponsors considering implementing Roth contributions in the middle of 2006 may want to advise participants of this possibility earlier in the year. Otherwise, Roth contributions may be effectively unavailable to participants who are interested in making Roth contributions in 2006, but who reach the 2006 \$15,000 (\$20,000 for catch-up eligible participants) elective deferral limit before Roth contributions are made available.
- Plans using automatic Roth contribution enrollment should ensure that the automatic enrollment with Roth contributions is timely communicated to potential automatic enrollees.
- Plan administrators will need to update their systems for the new basis recordkeeping, rollover recordkeeping, Form W-2, and Form 1099-R requirements.

Plan administrators will need to prepare procedures and notices for the rollover statements required by the proposed regulations that will go into effect in 2007. Further, because plans will need to track rollover contributions in 2007 and later years, the IRS suggests that plans accepting direct Roth rollover contributions in 2006 request a statement from a transferor plan that states (1) that the amount rolled in is from a

designated Roth account and (2) the participant's investment in the contract (i.e., the participant's basis).

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We anticipate submitting comments on the proposed regulations for a number of clients. Please call David Levine, Lou Mazawey, or David Powell if you have any questions or would like to participate in the submission of comments.