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On the Horizon: Roth 401(k) Contributions Are Coming in 2006

By Eric Keller and Ethan Lipsig

Beginning in 2006, 401(k) plans may permit employees to designate some or all of their contributions as after-tax Roth contributions, which will make distributions (including earnings) tax-free. This Client Alert summarizes the requirements for Roth 401(k) contributions, analyzes their advantages and disadvantages, and outlines an action plan for employers that wish to permit them.

Roth 401(k) Contribution Requirements

Overview

The Economic Growth and Tax Relief Reconciliation Act of 2001 added a new Section 402A to the Internal Revenue Code (the "Code"), authorizing Roth contributions beginning after December 31, 2005. Earlier this year, the IRS proposed Roth 401(k) regulations for plan years beginning on or after January 1, 2006. In the news release accompanying the proposed regulations, the IRS stated its intention "to finalize the rules in time for plan sponsors to implement this valuable retirement savings opportunity beginning in 2006."¹ Code Section 402A and the proposed regulations establish the following requirements:

Irrevocable Designation; Treated as Wages. If a plan permits Roth 401(k) contributions, an employee must irrevocably elect Roth treatment at the time of the employee's cash or deferred election.² The employer must treat Roth 401(k) contributions as wages subject to the applicable withholding requirements at the time the employee would have received the income.³

Separate Accounting. Roth 401(k) contributions must be credited to a Roth 401(k) contribution account and a separate record must be maintained of the employee's "investment in the contract" (that is, the Roth 401(k) contributions that have not been distributed).⁴ Investment gains and losses (and any other credits or charges) must be separately allocated to the Roth 401(k) contribution account on a reasonably consistent basis. Plan forfeitures cannot be allocated to Roth 401(k) contribution accounts.⁵

Elective Deferral Rules Apply. Roth 401(k) contributions must be treated as elective deferrals in all respects, except for

the differences in tax treatment.⁶ Consequently, Roth 401(k) contributions are subject to the annual limit on elective deferrals under Code Section 204(g) (\$15,000 in 2006), catch-up contribution limit (\$5,000 in 2006), and the ADP nondiscrimination requirements.⁷ These limits are applied to regular elective deferrals and Roth 401(k) contributions on an aggregate basis. In addition, Roth 401(k) contributions are taken into account under the deduction rules, the top-heavy rules, the 415 limits, the 100% vesting requirement, and the required minimum distribution rules in the same manner as regular elective deferrals.⁸ Because Roth 401(k) contributions are subject to the same rules as other elective deferrals, Roth 401(k) account balances may only be distributed following a participant's termination of employment, death, disability, attainment of age 59 ½ or hardship.

ADP Violation Corrective Distributions. A highly compensated employee ("HCE") who contributes both regular elective deferrals and Roth 401(k) contributions may be permitted to elect whether excess contributions that must be distributed to cure an ADP test violation will be taken from the HCE's regular elective deferrals or Roth 401(k) contributions for the plan year.⁹ If corrective distributions of Roth 401(k) contributions are made, the earnings distributed with the contributions are taxable.

Excess Deferrals. If a participant contributes both regular elective deferrals 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), the excess must be distributed back to the participant. 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 they were already subject to taxation when contributed; however, earnings attributable to these excess Roth contributions will be taxed when distributed.¹⁰ On the other hand, if a plan fails to distribute excess Roth 401(k) contributions by the April 15th deadline, the Roth 401(k) contributions will be subject to double taxation – when contributed and again when distributed along with earnings on them.¹¹

Matching Contributions. Only elective deferrals can be made on a Roth, after-tax basis. Consequently, employer matching contributions on Roth 401(k) contributions will continue to

be treated as pre-tax contributions subject to taxation when distributed.

Holding Period. To be tax-free, Roth 401(k) account distributions must occur after (1) a participant's attainment of age 59 ½, the participant's death, or the participant becoming disabled, and (2) more than five years after the participant's first Roth 401(k) contribution to the plan or a predecessor plan.¹²

Rollovers. Participants may roll Roth 401(k) account balances to the Roth account of another 401(k) plan or to the participant's Roth IRA.

Plan Amendments

Employers will need to amend their 401(k) plans to permit Roth 401(k) contributions. Based on recent practice, it is likely that the IRS will publish model amendments implementing Roth 401(k) features that must be adopted by the end of the plan year in which a plan first accepts Roth 401(k) contributions.¹³

Open Issues

Several open issues are expected to be addressed in the soon-to-be-finalized Roth 401(k) regulations. These issues include:

- tracking Roth 401(k) rollovers for purposes of complying with the 5-year holding period requirement;
- tax treatment of non-qualifying distributions from Roth 401(k) accounts; and
- Roth 401(k) contributions to safe harbor plans.

Pros and Cons

Roth 401(k) contributions have two big advantages. The primary advantage is that earnings are not taxed. This may be particularly advantageous for younger, lower-paid participants who have a longer retirement horizon and for whom the benefit of a tax-free distribution will significantly outweigh the up-front tax cost.

The other Roth 401(k) contribution advantage is that much higher contributions can be made than to a Roth IRA. While Roth 401(k) contributions are tied to the annual elective deferral limit (\$15,000 in 2006, \$20,000 for participants age 50 or older), the maximum contribution to a Roth IRA is dramatically lower (\$4,000 in 2006, \$5,000 for participants age 50 or older). Moreover, the Roth IRA contribution limit is reduced, and eventually eliminated, as adjusted gross incomes exceed \$160,000 for joint filers and \$110,000 for unmarried filers. Therefore, whether making Roth 401(k) contributions is advantageous to a participant will depend on the participant's individual circumstances, including the participant's ability to contribute to a Roth IRA outside the

plan, the availability of an employer matching contribution on Roth 401(k) contributions, and the relative value of deferred taxation of both contributions and earnings as compared to current taxation of contributions and no taxation of earnings.

The disadvantage of permitting Roth 401(k) contributions is that administering them expands compliance and recordkeeping responsibilities and may increase costs. Roth 401(k) contributions are subject to a "sunset" provision: absent further Congressional action, Roth 401(k) contributions will no longer be available after December 31, 2010. Employers that decide to implement a Roth 401(k) contribution feature should fully disclose this potential drawback to employees.

Action Plan for Employers

Plan sponsors will have to take several steps to implement Roth 401(k) contributions:

- First, a plan sponsor will need to confirm that its recordkeeper can separately account for Roth 401(k) contributions. Recordkeeping and payroll systems may need to be modified.
- Second, a plan sponsor will want to determine what Roth 401(k) features will be implemented in its 401(k) plan, and when they will be implemented. For example, plan sponsors will need to determine how Roth 401(k) contributions fit into the plan's distribution hierarchy – whether distributions will be made first from regular 401(k) contributions, from Roth 401(k) contributions or as employees elect.
- Third, after the IRS issues its final Roth 401(k) regulations, a plan sponsor will need to prepare plan amendments implementing Roth 401(k) features, perhaps by adopting IRS model amendment language.
- Fourth, a plan sponsor will need to prepare new election forms and communications (including new summary plan descriptions) to provide employees with the information necessary to make an informed decision about whether to designate all or a portion of their elective deferral contributions as a pre-tax or an after-tax Roth contribution.
- Fifth, the plan should be submitted for a determination letter in accordance with the EGTRRA determination letter process that was recently promulgated by the IRS.¹⁴

Plan sponsors who wish to implement a Roth 401(k) feature by January 1, 2006 should not wait until the IRS issues its final regulations to get started. There is a lot of work that will need to be done before the feature can be implemented. Plan sponsors who do not start any of these preliminary steps until the final regulations are released later this year may not have enough time to implement their program by January 1st of next year.

Conclusion

Roth 401(k) contributions provide a welcome and potentially valuable retirement planning alternative that is expected to be quite popular with many employees. On the other hand, if Congress does not eliminate the sunset requirement, Roth 401(k) contributions will be a temporary feature. [SC](#)

NOTES

1. Tax-sheltered annuity 403(b) plans also may accept Roth contributions. The IRS's news release stated that rules similar to the Roth 401(k) contributions rules would apply to 403(b) plans.
2. Prop. Treas. Reg. § 1.401(k)-1(f)(1)(i).
3. Prop. Treas. Reg. § 1.401(k)-1(f)(1)(ii).
4. Prop. Treas. Reg. § 1.401(k)-1(f)(1)(iii).
5. Id. Prop. Treas. Reg. § 1.401(k)-1(f)(2).
6. Code § 402A(a)(1).
7. Prop. Treas. Reg. § 1.401(k)-1(f)(3). Note the distinction between traditional after-tax contributions, which are subject to ACP testing and not subject to the elective deferral rules, and Roth 401(k) contributions, which are subject to ADP (not ACP) testing and are subject to all the other restrictions and limitations on elective deferrals. 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).
8. Prop. Treas. Reg. § 1.401-1(f)(3).
 9. Prop. Treas. Reg. §§ 1.401(k)-2(b)(1)(ii) and 1.401(k)-2(b)(2)(vi)(C).
 10. See Code § 402A(d)(2)(C).
 11. See Code § 402A(d)(3).
 12. Code § 402A(d)(2).
 13. See, e.g., Notice 2005-3.
 14. See Rev. Proc. 2005-66.

If you have any questions regarding Roth 401(k) contributions for 2006, or employment law matters in general, please contact any of the following attorneys:

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