

Coming in 2006: Roth 401(k) Accounts

One of the last legacies of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") are "Roth 401(k) accounts" under 401(k) plans. Beginning in 2006, employers will have the option to permit employees to make "Roth 401(k) contributions" under their 401(k) plans. Similar to the popular Roth IRAs, Roth 401(k) contributions are made on an after-tax basis, and "qualified" distributions are completely tax-free, including the earnings. However, Roth 401(k) accounts have two significant advantages over Roth IRAs.

- ◆ The annual contribution limit is the same as the limit on 401(k) contributions (\$15,000 in 2006), which is significantly higher than the limit on contributions to Roth IRAs.
- ◆ Roth 401(k) accounts are available to all participants, regardless of gross income level. (Under present law, single individuals whose gross income is more than \$110,000 and married individuals whose gross income is more than \$160,000 are excluded from making contributions to a Roth IRA.)

On March 2, 2005, the IRS issued proposed regulations for Roth 401(k) accounts, providing useful guidance, but not all the answers, for employers who may be considering the addition of Roth 401(k) accounts. Roth 401(k) accounts are optional and are treated similar to 401(k) pre-tax accounts in most respects, thereby giving employees a choice between pre-tax and after-tax contributions.

Helping employees determine which type of contribution is best may provide an education challenge to employers. To be ready for 2006, plan sponsors who are considering this change to their 401(k) plans may want to begin now the process of working with their recordkeepers and other service providers to ensure that the requirements under the proposed IRS regulations will be satisfied.

General Requirements for Roth 401(k) Accounts

Under the IRS proposed regulations, the operation of Roth 401(k) accounts must satisfy the following requirements:

- ◆ The plan must be amended to permit Roth 401(k) contributions. (Note: The deadline for amending plans has not yet been established by the IRS.)

- ◆ Each participant must elect to designate the contribution irrevocably as a Roth 401(k) contribution in lieu of all or a portion of his pre-tax elective contributions under the plan.
- ◆ Roth 401(k) contributions are treated as taxable wages subject to the applicable withholding requirements (both income tax and FICA).
- ◆ Roth 401(k) contributions, and the related earnings and losses on such contributions, must be accounted for separately under the plan, even if the plan already permits after-tax contributions.

In addition to these requirements, the Roth 401(k) contributions must also be coordinated with certain 401(k) contribution limits and other restrictions.

Contribution Limits and Other Restrictions

For income tax purposes, Roth 401(k) contributions will be treated as after-tax contributions. However, for purposes of the annual deferral limitation applicable to 401(k) plans (which will increase to \$15,000 for 2006), Roth 401(k) contributions will be treated as interchangeable with pre-tax contributions. For example, in 2006, a participant's combined pre-tax and Roth 401(k) contributions cannot exceed \$15,000 (or \$20,000 if the plan permits "catch-up" contributions for those eligible employees who have attained age 50). The rule allowing some taxpayers to convert traditional IRAs to Roth IRAs on a taxable basis does not allow conversion of traditional 401(k) accounts to Roth 401(k) accounts.

Roth 401(k) contributions must also be included in the actual deferral percentage ("ADP") nondiscrimination testing. (Note: Under the proposed IRS regulations, plans may permit highly compensated employees who make both Roth 401(k) contributions and traditional pre-tax 401(k) contributions to elect whether to receive any corrective distributions from their pre-tax or Roth 401(k) contributions.) In addition, unlike Roth IRAs, Roth 401(k) contributions will be subject to the minimum required distribution rules at age 70½. In most other respects Roth 401(k) contributions are subject to the same rules that apply to other 401(k) contributions. Thus, Roth 401(k) contributions must be non-forfeitable when made and generally cannot be withdrawn before age 59½ except for financial hardship.

“Qualified” Distributions

“Qualified” distributions of Roth 401(k) contributions and the related earnings will not be subject to federal income taxes. A distribution is “qualified” if it is made after the participant reaches age 59½, or on account of the participant’s death or disability, and is made at least five years after the date the first Roth 401(k) contribution was made. Amounts in Roth 401(k) accounts may be rolled over to a Roth IRA or to another 401(k) plan or 403(b) program that accepts Roth 401(k) contributions. Distributions that are not “qualified” trigger federal income taxes on the earnings, but not the contributions.

Changes to Recordkeeping and Payroll Systems

Amending a 401(k) plan to permit Roth 401(k) contributions will require consideration of the changes to the employer’s recordkeeping and payroll systems for the plan. Under the proposed IRS regulations, the plan’s recordkeeping system must account for Roth 401(k) contributions separately and must also handle the different tax reporting of qualified and non-qualified distributions from that account. In addition, the employer’s payroll system must be modified to reflect the different tax treatment of the payroll deductions associated with Roth 401(k) contributions (including the different tax withholding and Form W-2 reporting) if the 401(k) plan does not already offer after-tax contributions.

Employee Communications

Employers who amend their plans to add Roth 401(k) accounts will need to communicate this change to plan participants (i.e., revise the summary plan description). It may also be advisable to provide additional information regarding the Roth 401(k) accounts in order to encourage plan participation and avoid confusion by participants in deciding whether to make Roth 401(k) contributions or 401(k) pre-tax contributions.

Issues Not Addressed under Proposed IRS Regulations

The proposed IRS regulations do not provide specific guidance on a number of issues, including the following:

- ♦ Coordination with any existing after-tax contributions under a 401(k) plan;
- ♦ “Ordering” procedures and other rules associated with the tax consequences for distributions of Roth 401(k) contributions.
- ♦ Coordination with the IRS safe-harbor contribution rules under Code Sections 401(k) and 401(m);
- ♦ Clarification of the application of the five-year requirement for determining whether a distribution of Roth 401(k) contributions is “qualified”;
- ♦ Coordination with the IRS automatic rollover rules that became effective March 28, 2005; and
- ♦ Clarification of how EGTRRA’s “sunset” provision (i.e., EGTRRA is set to expire in 2010 unless Congress acts to make its provisions permanent) would affect the operation of Roth 401(k) accounts.

If you have any questions concerning Roth 401(k) accounts, please contact the Seyfarth Shaw LLP Employee Benefits Group attorney with whom you work or any Employee Benefits attorney on the website at www.seyfarth.com.

This newsletter is a periodical publication of Seyfarth Shaw LLP and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have. For further information about these contents, please contact the firm’s Employee Benefits Practice Group.

ATLANTA

One Peachtree Pointe
1545 Peachtree Street, N.E., Suite 700
Atlanta, Georgia 30309-2401
404-885-1500
404-892-7056 fax

BOSTON

Two Seaport Lane, Suite 300
Boston, Massachusetts 02210-2028
617-946-4800
617-946-4801 fax

CHICAGO

55 East Monroe Street, Suite 4200
Chicago, Illinois 60603-5803
312-346-8000
312-269-8869 fax

HOUSTON

700 Louisiana Street, Suite 3700
Houston, Texas 77002-2797
713-225-2300
713-225-2340 fax

LOS ANGELES

One Century Plaza
2029 Century Park East, Suite 3300
Los Angeles, California 90067-3063
310-277-7200
310-201-5219 fax

NEW YORK

1270 Avenue of the Americas, Suite 2500
New York, New York 10020-1801
212-218-5500
212-218-5526 fax

SACRAMENTO

400 Capitol Mall, Suite 2350
Sacramento, California 95814-4428
916-448-0159
916-558-4839 fax

SAN FRANCISCO

560 Mission Street, Suite 3100
San Francisco, California 94105
415-397-2823
415-397-8549 fax

WASHINGTON, D.C.

815 Connecticut Avenue, N.W., Suite 500
Washington, D.C. 20006-4004
202-463-2400
202-828-5393 fax

BRUSSELS

Boulevard du Souverain 280
1160 Brussels, Belgium
(32)(2)647.60.25
(32)(2)640.70.71 fax