



Electronic Dispatch

Employee Benefits Law Action Memo

February 2006

[Go to BS&K Employee Benefits Home Page](#)

MORE GUIDANCE ON ROTH 401(k) AND 403(b) PLANS

401(k) and 403(b) plans that provide for traditional elective pre-tax contributions may now include a qualified Roth contribution program that would allow participants to make elective after-tax contributions if certain requirements are satisfied. Many plan sponsors have hesitated adopting a Roth contribution program, however, due to several open issues (e.g., questions concerning the taxation of distributions). In January, 2006, the Internal Revenue Service ("IRS") finalized the Section 401(k) proposed regulations that were described in our April, 2005 Employee Benefits Law Information Memorandum, and issued additional proposed regulations addressing the taxation of distributions from designated Roth accounts, rollovers, reporting requirements, designated Roth contributions under a 403(b) plan, and related guidance.

Taxation of Distributions

A qualified distribution from a designated Roth account is not includible in income. A qualified distribution must satisfy two requirements:

- it must be made 5 or more consecutive taxable years after the first day of the participant's taxable year for which the participant first had designated Roth contributions to the plan (or, in the case of a rollover of designated Roth contributions, to the distributing plan) (the "5-Year Requirement"); and
- it must be made on or after age 59 ½, or on account of death or disability.

Loans that are deemed distributions, and dividends distributed with respect to employer securities, are never qualified distributions.

If a distribution does not satisfy the foregoing requirements, it is a nonqualified distribution taxable as a separate contract under Section 72 of the Internal Revenue Code ("Code"). Section 72 of the Code requires a proportionate distribution of income and "investment in the contract" (i.e., the after-tax designated Roth contributions). For example, if a \$10,000 designated Roth account is comprised of \$9,400 in designated Roth contributions and \$600 in earnings, a \$5,000 nonqualified distribution will consist of \$4,700 of designated Roth contributions (not includible in income) and \$300 of earnings (includible in income).

If a nonqualified distribution is rolled over into a Roth IRA, only the non-taxable return of investment in the contract will be treated as basis in any subsequent distribution.

Rollovers

Rollovers from a designated Roth account in a 401(k) plan may be made only to another 401(a) plan that agrees to separately account for the amount not includible in income, and only in the form of a direct rollover. The same restrictions apply to 403(b) plans (i.e., only to another 403(b) plan, and only in a direct rollover). The distributing plan must report the investment in the contract (i.e., the designated Roth contribution component of the distribution) and the first year of the 5-year period to the recipient plan.



Alternatively, a designated Roth account may be rolled over to a Roth IRA in either a 60-day rollover (where the participant first receives the distribution, and subsequently rolls it over) or a direct rollover. If only a portion of the distribution is rolled over, the portion not rolled over is treated as consisting first of the amount of the distribution that is includible in income. The taxable portion of the distribution can be rolled over into a 403(b) plan or a 401(a) plan within the 60-day period following distribution. However, the recipient plan will have additional reporting responsibilities with respect to these amounts, and the period of participation under the distributing plan will not count towards the 5-Year Requirement under the recipient plan.

If a designated Roth account is rolled over into a Roth IRA, the 5-Year Requirement applicable to designated Roth contributions, and the 5-year distribution restriction period for Roth IRA contributions, are determined separately (the latter is measured from the first taxable year in which a contribution is made to any Roth IRA). However, if the Roth IRA was established prior to the designated Roth account, the earlier Roth IRA contribution date governs all distributions from that IRA, including the amount attributable to a rollover contribution from a designated Roth account. Further, if a qualified distribution is rolled over into a Roth IRA, any subsequent distributions of the rollover amount (even distributions that would not satisfy the 5-year distribution restriction applicable to Roth IRAs) are not includible in income (although investment return on the rollover earned in the Roth IRA is not excludible until the Roth IRA 5-year holding period is satisfied).

Excess Deferrals

Contributions in excess of the Code Section 402(g) limit (aggregating both designated Roth contributions and traditional pre-tax elective contributions) must be distributed by April 15th of the year following the year of excess. If excess designated Roth contributions are not distributed by that date, the distribution is includible in income with no exclusion for basis (despite the fact that they were taxed in the year of contribution). Income for the period between the end of the year and the distribution must also be distributed, effective January 1, 2007.

Roth Contributions To a 403(b) Plan

The proposed regulations essentially copy the rules for designated Roth contributions to a 401(k) plan into the 2004 proposed Code Section 403(b) regulations, with one major exception: the universal availability rule applicable to salary reduction contributions to a 403(b) plan also applies to designated Roth contributions. If any employee has a right to make a designated Roth contribution to a 403(b) plan, then all employees must be offered that right. The proposed regulations will not apply before the effective date of the final 403(b) regulations (the final 403(b) regulations are expected to be issued later this year, and it is anticipated that they will have an effective date of January 1, 2007).

Reporting and Recordkeeping

The proposed regulations impose a number of reporting and recordkeeping requirements on plan sponsors maintaining a Roth contribution program beginning in 2007, including:

- tracking the 5-year period and the amount of designated Roth contributions;
- within a reasonable period following a direct rollover (but not later than 30 days), reporting to the recipient plan either (1) the first year of the 5-taxable year period and the portion of the distribution that consists of designated Roth contributions, or (2) that the distribution is a qualified distribution;
- providing the foregoing information to a participant upon request following a distribution, except that disclosure of the first year of designated Roth contributions is not required; and
- requiring recipients of a 60-day rollover to notify the IRS of its acceptance of the rollover.

Effective Date

The proposed regulations are generally effective January 1, 2007, except that the following rules are effective January 1, 2006:

- the coordination between designated Roth accounts and Roth IRAs;
- the requirement that no transaction or accounting methodology has the effect of transferring value from other accounts to the designated Roth account; and
- the taxation rules on distributions that are rolled over.

If you have any questions, please contact Amelia Klein (518-533-3217; aklein@bsk.com) or any of the other members of our Employee Benefits Law Practice Group listed below:

In Central New York, call 315-218-8000 or e-mail:

Lisa A. Christensen	lchristensen@bsk.com
Stephen C. Daley	sdaley@bsk.com
Brian K. Haynes	bhaynes@bsk.com
Richard D. Hole	rhole@bsk.com
Ted Lewkowicz	tlewkowicz@bsk.com
Aaron M. Pierce	apierce@bsk.com

In the Capital District, call 518-533-3000 or e-mail:

Joanmarie M. Dowling	jdowling@bsk.com
----------------------	--

In Western New York, call 716-566-2800 or e-mail:

Darcie A. Falsioni	dfalsioni@bsk.com
--------------------	--