



Electronic Dispatch

# Employee Benefits Law Information Memo

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## GUIDANCE ISSUED ON HOW TO GIVE 401(k) PARTICIPANTS AN OPTION TO MAKE AFTER-TAX "ROTH" CONTRIBUTIONS

On March 2, 2005, the Internal Revenue Service ("IRS") issued proposed regulations that provide important guidance for employers interested in adding an option to their 401(k) plans that would allow participants to make after-tax "Roth" contributions to those plans ("Proposed Regulations"). These "Roth" contributions would be contributed by a participant to an eligible 401(k) plan with after-tax dollars (e.g., with wages that the participant received from the employer that already have been taxed by the employer), and would then be distributed (along with any earnings on such contributions) on a tax-free basis from the 401(k) plan if certain requirements are satisfied.

Employers wishing to add this option to their 401(k) plans may do so starting with the first plan year beginning after December 31, 2005. Amendments will need to be made to such plans, and new administrative procedures will need to be established, in order to allow after-tax "Roth" contributions to be made. Among the issues employers will want to consider prior to adding an after-tax "Roth" contribution option to their 401(k) plans is the fact that the statute that authorized this option is scheduled to expire in 2010 (along with many other tax provisions that were enacted at the same time). It is not clear at this time whether Congress will delay or repeal this expiration date.

Employers with tax-sheltered annuity plans under Section 403(b) of the Internal Revenue Code ("Code") will also have the option, starting with the first plan year beginning after December 31, 2005, to add an after-tax "Roth" contribution option to such plans. The IRS has yet to issue the applicable guidance for these employers, but it is expected to be similar to the Proposed Regulations.

### What Is the Annual Dollar Limit For After-Tax "Roth" Contributions To An Eligible 401(k) Plan?

The annual dollar limit on the amount of after-tax "Roth" contributions that a participant can make to an eligible 401(k) plan is, in general, the annual Code limit on salary reduction contributions to a 401(k) plan (which, in 2006, will be \$15,000), reduced by the amount of salary reduction contributions the participant made to the 401(k) plan during the applicable year. Thus, for example, if such a participant is going to make \$10,000 in salary reduction contributions during 2006, the amount of after-tax "Roth" contributions the participant could make in 2006 generally would be \$5,000 (this assumes, among other things, that the actual deferral percentage test is satisfied with respect to such contributions).

The Code limit on salary reduction contributions to a 401(k) plan is subject to cost-of-living adjustments. If a participant is eligible to make age 50 catch-up contributions under the Code, the annual limit on such contributions (which, in 2006, is \$5,000) could be added to the Code limit on salary reduction contributions if the applicable requirements are satisfied (this would result in a total limit in 2006 of \$20,000, which would then apply to the combined salary reduction contributions and after-tax "Roth" contributions made by the participant in 2006 if the applicable requirements are satisfied).

### Why Did Congress Add the After-Tax "Roth" Contribution Option For 401(k) Plans?

Congress established Roth IRAs in 1997 in order to allow certain individuals to make after-tax contributions to an IRA, and to allow qualified distributions to be made from such an IRA that would be excludable from income. Congress concluded that there were a number of reasons why some individuals may prefer to save through a Roth IRA rather than a traditional pre-tax IRA. Congress believed that a similar savings choice should be available to participants in 401(k) plans and tax-sheltered annuity plans, and authorized such a choice under the Economic Growth and Tax Relief Reconciliation Act of 2001 for plan years beginning after December 31, 2005.

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If a 401(k) participant believes that he or she will be in a higher tax bracket in his or her retirement years, after-tax Roth contributions to the 401(k) plan might be more advantageous than pre-tax salary reduction contributions to the 401(k) plan. However, there are several variables that should be considered with respect to such a decision, and a financial analysis would be the best way for a participant to determine which type of 401(k) contributions would likely be more advantageous.

### What Guidance Is Provided By the Proposed Regulations About Establishing a Roth 401(k) Plan?

A 401(k) plan may permit a participant who makes elective contributions to designate some or all of those contributions as after-tax Roth contributions, starting with the first plan year beginning after December 31, 2005. Guidance provided by the Proposed Regulations about such contributions includes the following:

- Designated Roth Contributions – In order for a 401(k) contribution to qualify as a designated Roth contribution, it must (among other things) be an elective contribution under a 401(k) plan that is: (1) designated irrevocably by the participant at the time it is contributed as a designated Roth contribution; and (2) treated by the employer as includible in the participant's income at the time the participant would have received the contribution amount in cash if the participant had not made the contribution to the 401(k) plan (the contribution generally would be treated as wages subject to applicable withholding taxes).
- Separate Accounting Requirement – A designated Roth contribution account must be established under a 401(k) plan for each participant who makes a designated Roth contribution. A participant's contributions and withdrawals of designated Roth contributions must be credited and debited to his or her designated Roth contribution account, and the 401(k) plan must keep a record of the participant's designated Roth contributions that have not been distributed. Gains, losses, and other credits and charges must be separately allocated on a reasonable and consistent basis to a participant's designated Roth contribution account. Forfeitures, however, may not be allocated to the designated Roth account.
- Designated Roth Contributions Generally Must Satisfy the Requirements Applicable to 401(k) Pre-Tax Elective Contributions, Including the Actual Deferral Percentage Test – Designated Roth contributions generally must comply with the same requirements that apply to 401(k) pre-tax elective contributions, including the nonforfeitability, distribution restriction, and minimum distribution requirements that apply to 401(k) pre-tax elective contributions. Designated Roth contributions will be taken into account under the actual deferral percentage ("ADP") nondiscrimination test in the same manner as 401(k) pre-tax elective contributions.

### When Can Distributions Be Made From a Designated Roth Contribution Account?

A distribution from a participant's designated Roth contribution account will not be includible in the participant's gross income to the extent it is a "qualified distribution." A "qualified distribution" is a distribution to a participant that is made after the end of the applicable five year nonexclusion period (which is defined as the five year taxable period beginning with the earlier of (1) the first taxable year that the participant made a designated Roth contribution to the applicable plan, or (2) if a rollover contribution was made to the participant's designated Roth contribution account from a designated Roth account previously established for the participant under another retirement plan, the first taxable year for which the participant made a designated Roth contribution to such previously established account), and that is:

- made on or after the date the participant attains age 59-½;
- made to a beneficiary (or to the estate of the participant) on or after the death of the participant; or
- attributable to the participant being disabled.

A plan may allow a participant to choose the character of a distribution (e.g., whether the distribution will come from the participant's designated Roth contributions account or from another participant account under the plan), as long as the provisions of the plan specify how such a choice will be made. A plan also must provide that a participant's designated Roth contributions may be rolled over only to another designated Roth contributions account the participant has in another plan or to a Roth IRA the participant has.

If you have any questions, please contact any of the following members of our Employee Benefits Law Group:

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