



ADDING A ROTH ACCOUNT OPTION TO 401(K) AND 403(B) PLANS

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1. INTRODUCTION

The Roth IRA is a wonderful vehicle for long term planning. Contributions are with after-tax dollars, and investment earnings are not taxed. Withdrawals are totally tax free, and minimum distribution rules at age 70½ do not apply. Starting in 2006, an account with most of these attributes (the "Roth feature") can be added to 401(k) and 403(b) plans.

Is it a good idea? We think so. But the attractive Roth features must be balanced against the cost of even more administrative complexity. The lead time to think through the new rules is short. IRS regulations were late to appear (March 2005), and it is clear that simple transactions, such as paying out tax-free benefits, will have layers of complexity.

2. THE LEGAL BACKGROUND

The 2001 tax act, known as EGTRRA, added Section 402A to the Code. Effective January 1, 2006, new 402A allows 401(k) plans and 403(b) annuities to add a Roth feature. 457(b) plans of governments and exempt organizations may not add a Roth feature.

IRS issued initial regulations in March 2005, which address some of the necessary issues if a Roth feature is added to a 401(k) plan. The regulations are expressly silent on the knotty tax distribution issues. Guidance for 403(b) sponsors was also not included in the March release, but is expected. We expect that IRS will confirm that 403(b) custodial accounts, which are treated as annuities for 403(b) purposes, will also be allowed to add a Roth feature.

Like many EGTRRA provisions, 402A is scheduled for sunset on December 31, 2010. Whether it is continued beyond that is anyone's guess.

3. TAX FEATURES: IT'S THE SAME, BUT DIFFERENT

For tax planning, the Roth feature is similar to the Roth IRA, with a few important exceptions.

- (a) **High income people can use the Roth feature.** A Roth IRA is not available to high income individuals and families. Joint filers are ineligible to make Roth IRA contributions when modified adjusted gross income ("MAGI") hits \$160,000. Phase-out

of the limit for joint filers starts at \$150,000. The limit is \$95,000 for single filers, with phase out occurring as MAGI approaches \$110,000. The Roth feature can be used by anyone, no matter how high their income. That's huge. (And because it is irrelevant to the Roth feature, we will skip explaining how MAGI is calculated.)

- (b) **No tax deduction.** Like the Roth IRA, there is no current tax benefit. Amounts contributed under a Roth feature will be included in current income as wages or, for partners and owners, as earnings.
- (c) **No tax (ever) on investment earnings.** This is the carrot. But all the conditions described in Sections 4 and 5 of this memo must be met, and the plan must be qualified when it makes the payment.
- (d) **Higher contribution limits.** The annual contribution limit for a Roth IRA is small, only \$4,000 in 2006 through 2007, and \$5,000 in 2008. Roth IRA "catch-ups" for those age 50 or more are \$1,000 in 2006 through 2008. Thereafter, the limits increase with cost of living adjustments. Roth IRA contributions may be made after age 70½ and are not limited due to active participation in a qualified plan.

Contributions under a Roth feature can be much larger, up to the full 402(g) and 414(v) limits that apply to 401(k) deferrals and catch-ups. That's a potential \$15,000 Roth feature contribution in 2006, plus an extra \$5,000 catch-up. It's another big plus for the Roth feature. But annual 401(k) discrimination testing may limit the Roth feature for "highly compensated employees" (i.e. in 2006, those who earned more than \$95,000 in 2005 from the plan sponsor). Although Roth feature contributions are after-tax, they are treated as before-tax 401(k) deferrals for annual 401(k) testing purposes. See Section 5 of this memo.

- (e) **Minimum distribution rules apply (a bit).** Roth IRA's do not have to make minimum distributions during the lifetime of the Roth IRA account holder. A spouse who is sole beneficiary of a Roth IRA can also postpone minimum distributions until death by assuming ownership of the Roth IRA. Unfortunately, plans with Roth feature money will have to make minimum distributions to older participants and beneficiaries under the 401(a)(9) rules.

Because transfers of Roth feature money to Roth IRA's in tax-free rollovers is permitted, we do not see this as a real problem for persons who do not want minimum distributions; it's just an extra step. Ultimately, most persons with Roth feature money will want to transfer all of it to Roth IRA's anyway, for additional planning flexibility without the concern of IRS plan qualification and minimum distribution rules.

4. HOOPS AND HURDLES FOR FAVORABLE TAX TREATMENT

- (a) Qualifying distributions. The whole point of adding the Roth feature is so that investment earnings will be free of tax. The Roth feature distribution must be a 402A "qualifying distribution."
 - (1) A "qualifying distribution" must be after age 59½, or death, or long term or total disability under Section 72(m)(7) standards. The "special purpose" reason allowed to Roth IRA's for first time home purchase does not apply. Deemed distributions due to loan default and hardship distributions are not "qualifying distributions." If a plan distributes Roth feature money for those latter reasons, the investment earnings will be taxable.

- (2) Earnings will be taxable if the Roth feature money is distributed to the individual within 5 taxable years of the first contribution to the Roth feature account. The year in which the contribution is made counts as an entire year.

Example: Jack makes a Roth feature contribution in April, 2006.

The five year requirement will be satisfied on January 1, 2011.

If the money in the plan's Roth feature account came from another plan's Roth feature, the investment period from that previous plan may be tacked on. Hopefully, IRS will allow recipient plans to accept participant certification. It's unclear what reporting requirements will apply to distributing plans. Note that it is not a plan qualification requirement that the plan maintain Roth money for 5 years. The plan can still make the distribution and, if less than 5 years has passed from the first contribution to the Roth feature, the participant can direct that it be transferred to a rollover Roth IRA so that it may appropriately age.

- (b) **Taxation of non-qualifying distributions.** If the distribution is "non-qualifying", how is it taxed? Is the employee's after tax "basis" for his contributions to the Roth feature spread out over all plan accounts, or is it focused solely on the plan's Roth feature account? We think the latter is the logical answer, but IRS seeks comments and has purposely avoided this in the March regulations.

5. REQUIREMENTS IF A PLAN OFFERS A ROTH FEATURE

- (a) **Discrimination tests.** In a 401(k) plan, the Roth feature must be generally available in a non-discriminatory manner, like any other plan feature. It is also subject to 401(k) discrimination testing as if it were a 401(k) deferral. A Roth feature in a 403(b) plan will probably have to be available to all eligible employees, under the same conditions as 403(b) deferrals. There is no additional discrimination testing requirement. In the running battle over which is the preferable vehicle for non-profit entities, this is a major victory for 403(b) proponents.
- (b) **In-service distribution restrictions.** Amounts contributed under a Roth feature are like 401(k) or 403(b) deferrals. In-service distributions before age 59½ are not permitted unless there is hardship.
- (c) **Keep Roth feature money separate.** Participants must irrevocably designate Roth feature contributions in advance. The Roth feature contributions and investment proceeds must always be separately accounted for, but need not be physically segregated from, other plan money. Forfeitures from other employees' accounts may not be added to Roth feature accounts.
- (d) **Return of excess contributions after failed 401(k) test.** If a plan fails its 401(k) test, it may permit participants to select whether Roth money or other deferrals will be returned first. Refunded after-tax contributions will remain non-taxable, and the investment earnings will be taxed under the normal timing rules (i.e. if distributed after March 15, taxable in the distribution year with a 10% employer penalty; otherwise taxable in the contribution year without employer penalty). Although not stated in the regulations, a plan could presumably implement a default procedure for participants who do not give timely instructions.

- (e) **Return of contributions which exceed the 402(g) limit (\$15,000 in 2006).** A plan must be certain that the total of deferrals and Roth feature contributions does not exceed the 402(g) limit for any year. Most plans have adequate payroll systems to prevent this from occurring. If there is a mistake, and if the refund is not made by the following April 15, the participant will be taxed (again) on the after-tax contributions made to the Roth feature, as well as the investment earnings!

That's really bad. But it's similar to the treatment for 401(k) deferrals which exceed the annual limit and are not refunded on time. Participants who are in deferral plans of more than one employer will have to be especially vigilant, because the 402(g) limit applies to all 401(k) and 403(b) plans in which the individual participates, even when the plans are sponsored by unrelated employers.

- (f) **Rollovers.** Direct rollovers may only be transferred to other Roth IRA's or to qualified plans with the Roth feature, and may not be transferred to traditional IRA's. This could be quite a chore for small cash-outs that include Roth feature money and traditional deferrals, due to the automatic rollover rule which now applies to accounts exceeding \$1,000.
- (g) **Full vesting.** The Roth feature money must be fully vested.

6. CONCLUSION

The decision to add a Roth feature is easy in some cases. A plan which primarily benefits highly-paid persons with substantial retirement benefits is a logical candidate. A 403(b) program with highly paid employees is another. A plan which has trouble passing the 401(k) test should probably not add the Roth feature. Why go through all the work if the Roth feature cannot be fully utilized due to testing problems?

And for those who did not know, William Roth was a five-term Republican senator from Delaware who died in 2003 at the age of 82. He received a bronze star in the Pacific, and was a champion, with Jack Kemp, against high taxes and government waste. In 1999 he wrote a book about the IRS, "The Power to Destroy." He reveled in disclosing excessive spending by the Pentagon, such as the famous \$640 toilet seat (when that was real money), and a \$9,600 wrench. The Roth IRA was a crowning achievement in his public life

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