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Preparing for Roth 401(k) Plan Accounts

Starting in 2006, plan sponsors can allow participants to make after-tax Roth contributions to 401(k) or 403(b) plans through a qualified Roth contribution program. Roth contributions are available under new Internal Revenue Code (the "Code") section 402A, which was added by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").

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Features of Roth Contributions

If a plan sponsor adds a "qualified Roth contribution program" to its 401(k) or 403(b) plan, participants may designate all or a portion of their elective contributions as Roth contributions. Roth contributions are taxed in the same manner as Roth IRA contributions; they are made on an after-tax basis and distributed tax-free. However, accumulated earnings on Roth contributions also are distributed completely tax-free. In addition, Roth contributions can be made by any plan participant since they are not subject to the gross income limitations which apply to Roth IRAs. (Contributions can not be made to a Roth IRA once a single person's adjusted gross income exceeds $110,000 or a married couple's income exceeds $160,000.)

Administrative Requirements

Roth contributions are treated the same as pretax elective deferrals for plan testing purposes. The combined deferral amount of both pretax and Roth contributions may not exceed the Code section 402(g) limits ($15,000 for 2006, plus catch-up contributions of $5,000). Because Roth contributions are elective deferrals, they must be fully vested and subject to the same distribution restrictions as pretax elective deferrals (no earlier than termination of employment, death, disability, or attainment of age 59). Roth contributions must be aggregated with pretax elective deferrals for ADP testing purposes (if not in a safe harbor plan). A plan can provide ordering rules for distributions of excess contributions from a failed ADP test. Or, a plan may permit a participant to elect to attribute the excess contributions to pretax or

Roth contributions. If the participant elects a corrective distribution of Roth contributions, the excess contribution is distributed tax?free, but earnings on the excess are includible in the participant's gross income. Roth contributions must be maintained by a plan in a separate "designated Roth account" for each

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participant. Earnings (gains or losses) must be allocated (separately) to the participant's pretax and Roth contribution accounts. A plan sponsor will also have to track a five-year holding period for Roth contributions since qualified distributions cannot be made during the five-calendar-year period beginning with the first calendar year in which a participant makes a designated Roth contribution to the plan. If a distribution is made during this five-year holding period, distributed earnings will be subject to taxation. Also, if Roth contributions are made under a plan that provides for automatic IRAs of terminated participants' accounts of $1,000 to $5,000, separate IRAs will have to be established for each account's Roth contribution portion and pretax contribution portion.

Additional Considerations

IRS guidance on implementing Roth contributions is anticipated, particularly on Roth 403(b) contributions and on recordkeeping for the five-year holding period, which is required for a qualifying distribution of Roth contributions. Also notable is that Congress has yet to extend EGTRRA's tax cuts, including Code section 402A on Roth contributions. These EGTRRA provisions are set to expire after 2010.

Participants, particularly high-income individuals, may be interested in Roth contributions based on an expectation that their marginal tax rate will either remain the same or increase during retirement. Tax rates may increase by legislative action or merely because an individual has fewer itemized deductions during retirement, which reduce the marginal tax rate. In addition, higher income individuals may be interested in Roth contributions because they can accumulate earnings on a tax-free basis until death if the Roth contribution rolled over into a Roth IRA. This is because Roth IRAs are not subject to required distributions after age 70. Other employees may be interested in Roth contributions as another opportunity to diversify their 401(k) accounts.

Action Plan

If you intend to add Roth contributions to your plan, you will want to consider these action steps:

1. Adjust the plan's recordkeeping and payroll systems to separately account for Roth contributions.

2. Prepare and distribute employee communications describing the benefits

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of Roth contributions, including a revised Summary Plan Description or a Summary of Material Modifications. Effective communications will be important in explaining this new option to employees.

3. Obtain new deferral election forms from participants prior to the time that Roth contributions are permitted.
4. Amend the plan to provide for Roth contributions and include provisions detailing the order in which distributions will be made from pretax contributions and Roth contributions. Plans must be amended by the end of the plan year in which Roth contributions are first permitted. For example, for a calendar-year plan that allows Roth contributions starting in 2006, an amendment to the plan will be required by December 31, 2006.

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