

Treasury Finalizes Proposed Regulations, Issues New Proposed Regulations, for Roth Contributions to 401(k) and 403(b) Plans

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In March 2005 the Treasury Department issued proposed regulations that provided guidance on the establishment and implementation of designated Roth contribution accounts in 401(k) plans. Recently these proposed regulations were finalized, with certain clarifying changes. While the final regulations set forth basic and definitional rules for a designated Roth program under a 401(k) plan, they do not address the taxability of distributions from designated Roth accounts or the reporting or recordkeeping requirements applicable to these accounts. These areas are addressed under a new set of proposed Treasury regulations recently issued, which also provide for the establishment of Roth contribution accounts in 403(b) plans.

- Clarifications in the final regulations.
 - Plans must offer pre-tax elective deferrals. Some commentators on the March 2005 proposed regulations requested that a sponsor of a 401(k) plan be allowed to offer only designated Roth contributions. The final regulations make clear that an employer offering designated Roth contributions must also offer pre-tax elective deferrals, based on the provision in Code section 402A(b)(1) that an employee may make designated Roth contributions *in lieu of* all or a portion of elective deferrals he would otherwise be eligible to make.
 - Only certain contributions may be made. The final regulations clarify that nothing other than designated Roth contributions and certain rollovers may be allocated to a designated Roth contribution account. Forfeitures, for example, may not be allocated.
 - Required distributions. Designated Roth contribution accounts are subject to the same required distribution rules under Code section 401(a)(9)(A) and (B) as pre-tax elective deferrals.
 - Frequency of elections. An employee in a plan that offers designated Roth contributions must be given the opportunity to make or change his or her designated Roth contribution election at least once per plan year. (This is the same rule that applies to pre-tax elective deferrals.)
 - Automatic enrollment. A plan may implement automatic enrollment using designated Roth contributions as the plan's default contribution, provided the plan sets forth the extent to which it uses designated Roth contributions as the default.
 - Direct rollovers. In response to commentators, the final regulations clarify that a direct rollover from a designated Roth account may only be made to another designated Roth account or to a Roth IRA. Also, the plan may consider the balance of the participant's designated Roth

contribution account as held under a separate plan from his or her other plan accounts when applying the rule under Treas. Reg. 1.401(a)(31)-1, Q & A-11. That is, a plan need not allow a direct rollover from a participant's designated Roth contribution account if the balance is less than \$200, regardless of the amounts in the participant's other plan accounts.

- The proposed regulations.

- Taxation of distributions. Under Code section 402A(d)(1), any qualified distribution from a designated Roth account (i.e., a distribution including earnings not previously taxed) is not taxable. A qualified distribution is a distribution that is made on or after the date the employee attains age 59-1/2, or upon the employee's death or disability, *and* after a 5-taxable-year period that begins, generally, with the first taxable year in which the employee makes a designated Roth contribution to the plan. A distribution that does not meet these requirements is not a qualified distribution. Also, distributions that are not treated as eligible rollover distributions (e.g., distributions of contributions in excess of Code section 415 limits, distributions of contributions in excess of the 401(k) dollar limit, or distributions to correct nondiscrimination testing failures) are not qualified distributions.

If a distribution is not a qualified distribution, it is includable in gross income to the extent it represents income on the employee's designated Roth account. The amount that represents the participant's designated Roth contributions is not taxable.

A distributee can avoid current taxation of any taxable portion of a distribution that is not qualified by rolling over the distribution to a Roth IRA or another designated Roth account. If the rollover is made to the designated Roth account of another plan and it consists of nontaxable amounts (amounts attributable to the participant's designated Roth contributions), however, it must be made as a direct rollover, and the recipient plan must be the same type of plan as the distributing plan. That is, if the distributing plan is a 401(k) plan, the recipient plan must be a 401(k) plan; if the distributing plan is a 403(b) plan, the recipient plan must be a 403(b) plan.

In addition, if a distribution from a Roth 401(k) or 403(b) account is rolled over in a direct rollover to another Roth 401(k) or 403(b) account, years credited toward the 5-taxable-year period under the distributing plan will be credited under the recipient plan. If the distribution is rolled over to a Roth IRA, however, there is no carryover of credit toward the 5-taxable-year period from the distributing plan to the Roth IRA.

- Distributions from Roth IRAs. Distributions from Roth IRAs cannot be rolled over to a designated Roth 401(k) or 403(b) account.
- Code section 403(b) plans. The proposed regulations provide that designated Roth contributions may be made to 403(b) plans. The rules that apply to designated Roth contributions to 401(k) plans apply to designated Roth contributions to 403(b) plans. The proposed regulations make clear that an employee's right to make elective deferrals, under the universal availability requirement under Code section 403(b)(12), includes the right to designate elective deferrals as designated Roth contributions.
- Reporting and Recordkeeping. The proposed regulations impose certain reporting and recordkeeping requirements on plan administrators of plans that provide designated Roth

contributions and/or accept rollovers from designated Roth accounts. Specifically:

- The 5-taxable-year period. The plan administrator (or other responsible party) of a plan that provides designated Roth contributions must keep track of the 5-taxable-year period for each employee for whom these contributions are made, and the amount of his or her designated Roth contributions.
- Statement. The plan administrator (or other responsible party) of a plan that directly rolls over a distribution must provide the plan administrator of the recipient plan with a statement indicating either that the distribution is a qualified distribution, or if it is not, providing the first year of the 5-taxable-year period for the employee and the portion of the distribution that is attributable to his designated Roth contributions. For distributions to the employee, the plan administrator must provide this statement to the employee upon his request (but the statement need not indicate the first year of the 5-taxable-year period.) The plan administrator must provide this statement within a reasonable period of time, but in no event later than 30 days after the direct rollover or employee request.
- Notification to Internal Revenue Service. If any taxable portion of a distribution from a designated Roth account is rolled over by the distributee (rather than by direct rollover) to another designated Roth account, the plan administrator of the recipient plan must notify the Internal Revenue Service of its acceptance of the rollover contribution.
- Reporting on Form 1099-R. It is anticipated that the instructions to Form 1099-R will change to provide that a separate Form 1099-R must be used to report the amount of a distribution from a designated Roth account, the taxable portion of the distribution, and the first year of the 5-taxable-year period.
- No reporting obligation for employees. An employee has no reporting obligation with regard to designated Roth contributions, but if he or she rolls over a distribution from a designated Roth account to a Roth IRA, he or she should keep track of the amount rolled over, as set forth in the instructions to Form 8606, “Nondeductible IRAs.”

- **Effective Dates**

The final regulations are generally applicable to plan years beginning on or after January 1, 2006. If a plan applied the final 401(k) regulations as of an earlier date, however, to the extent that designated Roth contributions were permitted under Code section 402A (for tax years beginning on and after January 1, 2006), the same early effective date applies to these final regulations. If the effective date of the final Code section 401(k) regulations for a plan is later than the date designated Roth contributions may first be made, the employer may rely on these final regulations until the final Code section 401(k) regulations apply to the plan. The final 401(k) regulations could apply to a plan earlier or later than the date designated Roth contributions may first be made, and earlier or later than the date the Roth 401(k) regulations would otherwise apply, for instance, if the plan year is not a calendar year.

The proposed regulations are generally effective for taxable years beginning on or after January 1, 2007. Rules regarding rollovers, however, are generally effective for taxable years beginning on or after January 1, 2006.

- **Plan Amendments**

An amendment introducing designated Roth contributions into a plan must be adopted by the end of the plan year in which it becomes effective. The Internal Revenue Service recently issued Notice 2006-44 which provides model language for designated Roth contributions. Plan sponsors are free to modify the language to fit the terms of their plans.

The final and proposed regulations impose considerable new responsibilities on plan sponsors that introduce designated Roth contributions to a 401(k) or 403(b) plan. The reporting and recordkeeping requirements under the proposed regulations, in particular, bring a new level of detail to the tracking and communication of elective contributions. Plan sponsors offering these accounts should provide sufficient information to participants so that they understand the features of designated Roth contributions and how they coordinate with the plan's pre-tax elective deferrals.

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