



Journal of Pension Benefits - Gucciardi and Ferenczy, 401(K) PLANS, (Apr. 1, 2006)

BY ILENE H. FERENCZY

Ilene H. Ferenczy is the co-editor-in-chief of the Journal of Pension Benefits, and the managing member of the Law Offices of Ilene H. Ferenczy, LLC, in Atlanta, GA. Ms. Ferenczy practices exclusively in benefits, specializing in qualified plans. She has written three textbooks on defined contribution plans, more than 50 articles on benefits issues, is the author of Employee Benefits in Mergers and Acquisitions, an Aspen publication, and is a national speaker. Ms. Ferenczy is the co-chair of the ASPPA Government Affairs Committee. She graduated summa cum laude from both Georgia State University College of Law and Western State University College of Law, and is a member of the Bar in California and Georgia.

Now that Treasury has issued final regulations regarding adding Roth features to our 401(k) plans, we have the answers to some of our questions on this new and anxiously awaited plan provision.

<http://prod.resource.cch.com/resource/scion/document/default/09013e2c857817e0?cfu=TAA>

At long last, the Treasury has issued final regulations relating to the addition of Roth features to our 401(k) plans. [T.D. 9237, modifying sections of [Treas. Reg. §§ 1.401\(k\)-1](#), [1.401\(k\)-2](#), [1.401\(k\)-6](#), [1.401\(m\)-2](#), and [1.401\(m\)-5](#), published in the Federal Register on January 3, 2006] We now have the answers to all... er... most... er... *some* of our questions on this new and anxiously awaited plan provision. Frankly, these regulations stop quite a bit short of making us ready to administer this type of plan provision fully, something of a *regulatus interruptus*. If the passage of the law itself takes us only to the first step in the process (that is, to first base), these regulations take us to second base, but no further.

What Is a Roth 401(k) Feature and a Designated Roth Contribution?

The Economic Growth and Tax Relief and Reconciliation Act (EGTRRA), added a provision to the Internal Revenue Code (Code or IRC), effective January 1, 2006, that permits participants to make after-tax contributions to a 401(k) plan, and receive tax benefits similar to those in a Roth IRA—that is, tax-free distribution of such funds and their earnings if such a distribution occurs under certain circumstances. The new regulations are also effective as of January 1, 2006.

The law and the new regulations define "designated Roth contributions " to be elective contributions under a 401(k) plan that are:

1. Irrevocably designated by the participant at the time of the cash or deferred election to be Roth contributions in lieu of any pre-tax contribution that is available to be made to the plan;
2. Treated by the employer as taxable income to the employee at the time the amount would otherwise have been paid to the participant; and
3. Maintained in a separate account. [[Treas.Reg. § 1.401\(k\)-1\(f\)\(1\)](#)]

These requirements have specific nuances that are used by the regulations to answer some of the questions practitioners have had since EGTRRA was enacted. For example, the introductory clause makes it clear that the plan must permit 401(k) elective contributions if designated Roth contributions are to be made. This is a clarification for those employers that contemplated converting the 401(k) plan or adopting a new plan to provide only for after-tax contributions. Roth contributions are a feature that is available only if and only to the extent that regular pre-tax salary deferrals are permitted.

Irrevocable Designation

The requirement of "irrevocable designation" means that, once an elective contribution is designated as a Roth contribution, it cannot be converted to a pre-tax amount. The reciprocal of this rule also applies. Unlike certain IRAs that can be converted into Roth IRAs, once an amount is designated as a pre-tax contribution under a 401(k) plan, it may not be converted by the participant into a designated Roth contribution.

Treatment as Taxable Income

The designation of the amount as a Roth contribution must be carried out by the employer through inclusion of the designated Roth contributions as after-tax amounts on the employee's [Form W-2](#) and by taking these amounts into account for employment taxes. [[Treas.Reg. § 1.401\(k\)-1\(f\)\(1\)\(ii\)](#)]

Separate Accounts

A 401(k) plan that provides for Roth contributions must account for these amounts separately. This separate account must reflect contributions and withdrawals of Roth funds. Both designated Roth contributions and permitted Roth rollovers may be added to this account; those two types of contributions can be commingled for accounting purposes. Earnings are then allocated to the designated Roth account on a reasonable basis.

The regulations make it clear that this separate accounting must be done from the time the Roth money is added to the plan until it is distributed. [[Treas. Reg. § 1.401\(k\)-1\(f\)\(2\)](#)] Therefore, Roth funds cannot be first placed in the elective contribution account under the plan and later reallocated to the designated Roth account.

Application of 401(k) Rules to Designated Roth Amounts

Other than the taxation at the time of contribution and the special rules relating to distributions, designated Roth contributions are subject to all other requirements of [Code Section 401\(k\)](#):

1. Participants must be given a reasonable opportunity at least once per year to elect or modify their elections as to the amount of designated Roth contributions;
2. Designated Roth contributions are limited (in conjunction with regular 401(k) elective contributions) to the annual [Section 402\(g\)](#) limit (\$15,000 in 2006);
3. They must be nonforfeitable at all times;
4. They are included in the ADP test;
5. They can be catch-up contributions; and
6. They are subject to the limitations on distributions of 401(k) elective contributions (*i.e.*, available only on death, disability, termination of employment, attainment of age 59½, and termination of the plan without adoption of an alternative defined contribution plan).

If a plan fails its ADP test, participants may be refunded designated Roth contributions instead of or in addition to the refunds of elective contributions. The designation of the refund amount may be made by the plan (*e.g.*, "All refunds of excess contributions shall be considered to be refunds of designated Roth contribution to the extent that such amounts were contributed during the plan year.") or the plan may permit the individual participant to elect how his or her refund should be characterized. [[Treas.Reg. § 1.401\(k\)-2\(b\)\(1\)\(ii\)](#)] Refunds of designated Roth contributions under these circumstances are not subject to taxation (*i.e.*, they have been taxed already), but any earnings allocated to those refunded amounts paid to the participant are taxed. [[Treas. Reg. § 1.401\(k\)-2\(b\)\(2\)\(vi\)\(C\)](#)]

A 401(k) plan that provides for automatic enrollment of participants may classify all or part of those automatic contributions as designated Roth contributions, rather than pre-tax elective contributions. [[Treas.Reg. § 1.401\(k\)-1\(f\)\(4\)\(ii\)](#)] The plan must explicitly state the default classification of the automatic contributions—Roth or pre-tax. Of course, the participant may affirmatively elect another designation of those contributions (or an amount of contribution different from the automatic level). If the plan designates the automatic enrollment to be Roth contributions, the employer's designation is considered tantamount to an irrevocable designation by the participant. [[Treas. Reg. § 1.401\(k\)-1\(f\)\(4\)\(ii\)\(B\)](#)] It is unclear whether a plan sponsor will tend to use pretax or designated Roth contributions for automatic enrollment. The impact on the ADP test is the same. On the other hand, the participant experiences an immediate tax savings with pre-tax contributions that is not present with designated Roth contributions, making the impact on the net paycheck less for pretax amounts. If the goal is to discourage affirmative declining of deferrals, automatic pre-tax contributions are likely to better further that goal.

Designated Roth contributions are treated as elective deferrals for purposes of [Code Sections 401](#), [402](#), [404](#), [409](#), [411](#), [412](#), [415](#), [416](#), and [417](#). Designated Roth contribution accounts are treated the same as 401(k) salary deferrals for purposes of the minimum required distributions at age 70½ under [Code Section 401\(a\)\(9\)](#). This rule is one of the things that distinguishes Roth 401(k) funds from those in Roth IRA

accounts, as the latter are not subject to the minimum required distribution rules before the death of the participant. [Treas. Reg. § 1.401(k)-1(f)(3)(l)]

Rollover Contributions of Roth Funds from a 401(k) Plan

The final regulations make it clear that a direct rollover of Roth amounts from a 401(k) plan may be made only to a designated Roth account in another eligible retirement plan, or to a Roth IRA. Furthermore, in determining whether a direct rollover must be offered, the plan administrator may treat the Roth portion of the plan separately from the pre-tax portion. Therefore, if there is less than \$200 in the Roth account of the plan, but more than \$200 in the pre-tax portion, the plan does not need to provide a direct rollover option for the Roth portion of the plan. [Treas.Reg. § 1.401(k)-1(f)(3)(ii)]

What Is Not in These Regulations?

These regulations answer most of the questions that a practitioner may have about Roth money going into a plan. Unfortunately, they contain no answers about how to qualify, account for, or otherwise treat distributed amounts. For example, the preamble to the regulations acknowledges that they do not discuss the taxation of distributions of designated Roth contributions. These issues are being addressed in regulations to [Code Section 408A](#), which were issued in proposed form in late January (and will be addressed in the next 401(k) column).

Other undiscussed issues include:

1. The mechanics of determining the five-year holding period for purposes of qualifying distributions;
2. The mechanics of tracking basis, and who is responsible for doing so for rollovers of Roth amounts; and
3. Any necessary modification of the required distribution taxation notice under [Code Section 402\(f\)](#) for accounts with Roth contributions.

Conclusion

Needless to say, many practitioners are concerned that whatever systems they initiate at the time a plan first begins to receive Roth amounts may not be set up properly to administer the distributable event years down the road. Similarly, plan sponsors are somewhat hesitant to institute a provision for which full guidance has not been issued. Therefore, we may find that the popularity of Roth 401(k) provisions is somewhat stunted until the Treasury provides guidance that gets us all the way from first or second base to home plate.