

QUALIFIED PLAN STRATEGIES

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Roth 401(k) Highlights

On December 30, 2005 the IRS issued final regulations on provisions allowing designated Roth contributions to a 401(k) plan. A 401(k) plan may now permit employees to designate some or all of their elective contributions, including catch-up contributions, as Roth contributions.

A 401(k) plan is not required to adopt Roth provisions. Elective contributions may be treated as designated Roth contributions only to the extent permitted under the plan.

Designated Roth contributions remain elective contributions (“salary deferrals”) for most plan purposes, but differ from pre-tax contributions in two important ways:

- Unlike pre-tax elective contributions, designated Roth contributions are included in the participant’s gross income at the time of the salary withholdings.
- “Qualified distributions” of designated Roth contributions and earnings will be tax free, whereas for pre-tax contributions and earnings taxation is deferred.

Designated Roth contributions to a 401(k) plan also differ from Roth IRA contributions in some important ways, which include:

- Unlike Roth IRAs (which have an income limit) plan participants may make Roth 401(k) contributions without regard to their adjusted gross income.
- Unlike Roth IRAs, a plan participant may not convert existing pre-tax elective contributions to Roth contributions.
- Unlike Roth IRAs, Roth 401(k) contributions are subject to required minimum distribution rules.

Designated Roth Contributions

A 401(k) plan may now elect to include provisions that permit participants to make after-tax Roth contributions in place of, or in conjunction with, pre-tax contributions, and Roth contributions are combined with the participant’s pre-tax contributions for purposes of applying the legal limits on the participant’s elective contributions. Roth contributions are defined as elective contributions under a 401(k) plan that are:

- Irrevocably designated by the participant (at the time of the contribution) as a Roth contribution, made in lieu of some or all of the pre-tax elective contributions available to the participant.
- The contributions are treated by the employer as included in the gross income of the participant.
- The contributions are maintained in a separate account.

Elective Deferral Requirement

A designated Roth contribution must satisfy the requirements applicable to any other elective contributions made under a 401(k) arrangement. For example, Roth contributions are non-forfeitable, eligible for match, included in the ADP test, subject to safe harbor 401(k) rules, may be treated as catch-up contributions, are subject to required minimum distributions, and are subject to distribution restrictions.

ADP Corrective Distributions

A distribution of excess contributions to correct ADP test failure is not includible in gross income to the extent it represents a distribution of designated Roth contributions. However, the income allocable to the distributed Roth contribution is includable in gross income (just as is income on pre-tax contributions).

For those Highly Compensated Employees (HCEs) with both Roth and pre-tax elective contributions, a plan may allow the HCE to elect which type of contribution to remove. However, because of the short window available for processing ADP-test corrective distributions, the plan should specify which correction method to use if an HCE does not make such an election.

Separate Accounting Requirement

An employee's contributions and withdrawals of designated Roth contributions must be credited and debited to a designated Roth account for the employee. Roth account gains, losses and other credits/charges must be allocated to the employee's Roth account.

No contributions may be allocated to the Roth account other than designated Roth contributions, and rollovers from other Roth 401(k) accounts. Rollovers from a Roth IRA to a Roth 401(k) account are not permitted. Contributions such as match or forfeitures may not be allocated to a Roth account.

This separate accounting rule only means that the account must be separately record-kept. It does not mean, for example, that the assets must be held in separate investment accounts.

Amendment Required

Because some choices must be made regarding the treatment of Roth contributions, such contributions should not be allowed until an amendment has been adopted. Having a plan amendment in place will also permit participants to receive a summary of the amendment and know how the Roth deferrals will be administered.

Miscellaneous Information

Stand-alone Roth Plans Not Permitted. The final regulations clarified that designated Roth contributions are "in lieu of" pre-tax elective contributions, and therefore pre-tax elective contributions must be allowed if Roth contributions are allowed.

Loans. Roth contributions may serve as the basis of determining the amount available for a participant loan. However, if a loan goes into default and therefore must be deemed to be a distribution, the earnings on the Roth amount would be taxable. Therefore, we recommend that all loans be funded from non-Roth sources.

Rollovers Out. Rollovers from a Roth account may only be made to another designated Roth account or to a Roth IRA.

Rollovers In. The regulations allow the rollover into a plan of contributions from a designated Roth account of a separate plan. However, a plan that allows Roth contributions is not required to allow Roth rollovers into the plan. A rollover from a Roth IRA is not allowed.

Cash-out. A plan is permitted to treat the balance of a participant's Roth account and the participant's other accounts under the plan as accounts held under two separate plans. Thus, if a participant's Roth account is less than \$200, the plan is not required to offer a direct rollover election with respect to that account, even if the participant's aggregate total in all accounts is over \$200.

Additional Information

For additional information, please contact your Benetech, Inc. representative, or call us at 800-925-7526.

The above highlights of the rules for Roth contributions to 401(k) plans are provided for general information purposes only, and should not be construed as advice regarding legal or tax issues. Both plan sponsors and plan participants should consult their legal or tax advisors regarding such issues.

The decision of whether to make Roth contributions to a plan should consider individual's personal financial and tax situation. An individual participant's decision may also be affected by his or her expectations regarding future changes in Federal income tax laws. Benetech, Inc. does not provide tax or legal advice.