TRANSAMERICA CENTER
FOR RETIREMENT STUDIES

TCRS 2005-02: Roth 401(k)

Background

The Economic Growth and Tax Relief Reconciliation Act of 2001 added section 402A to the Internal Revenue Code (IRC). Section 402A provides for designated Roth contributions to 401(k) plans. Unlike the Roth IRA, there is no income restriction for contributions to a Roth 401(k). Thus, employees, whose employers have amended their plans to add the Roth 401(k) feature, at any income level will be able to contribute to a Roth 401(k) beginning in 2006. Proposed regulations providing guidance on the implementation of Roth 401(k)s were issued by the Internal Revenue Service on March 1, 2005. Final regulations are expected to be issued this year in time for plan sponsors to amend their plans to add Roth 401(k) contributions for 2006, if they so desire.

Understanding the Basics of Designated Roth Contributions

- Will be available January 1, 2006.
- Are optional under a 401(k) plan.
- Available only to employees eligible to make elective contributions.
- Designated Roth contributions are elective contributions that are:
  - irrevocably designated by an employee as Roth contributions at the time of deferral;
  - treated by the employer as wages subject to applicable withholding requirements at the time the employee would have received the contribution amounts in cash; and
  - maintained in a separate account (money source) under the 401(k) plan.
- Separate accounting applies at the time the first contribution is made and continues to apply until complete distribution of the Roth account.
- A "qualified" distribution, as described below under "Rollovers and Distributions" from a Roth account will not be subject to taxation.

Nondiscrimination Requirements

- Designated Roth contributions are subject to the:
  - annual dollar limit on deferrals ($15,000 in 2006) under IRC section 402(g). This means, elective deferrals and designated Roth contributions are included in determining this limit;
  - average deferral percentage (ADP) test, but not the average contribution percentage (ACP) test;
  - overall contribution limits under IRC section 415;
  - top-heavy rules under IRC section 416; and
  - catch-up contribution limit ($5,000 in 2006). This means, the catch-up limit applies to a participant's combined pre-tax deferrals and designated Roth contributions.
- Designated Roth contributions will be treated as a benefit, right or feature under a plan, subject to the general nondiscrimination requirements of IRC section 401(a)(4).
- For purposes of the ADP test, a plan is permitted to specify whether pre-tax deferrals or designated Roth contributions will be returned first when reducing excess contributions by highly compensated employees. Alternatively, the plan may allow participants to choose which contributions are returned first.
- If the IRC section 402(g) limit is exceeded, designated Roth contributions that are distributed as excess deferrals on or before April 15 of the calendar year following the calendar year of contribution are not taxed again. However, earnings on these contributions are subject to taxation.
- If designated Roth contributions are not distributed as excess deferrals by the April 15th deadline, contributions are taxed upon distribution. Earnings are also taxed upon distribution.

Separate Accounting Requirement

- Designated Roth contributions must be kept separate from other types of contributions, even traditional after-tax employee contributions.
- Gains, losses, charges or credits are to be allocated separately to the designated Roth accounts.
- No forfeitures can be allocated to designated Roth accounts.

Vesting

- Designated Roth contributions are 100% vested at all times.

Rollovers and Distributions

- A qualified distribution, as described below, from a Roth 401(k) account may only be rolled over to another Roth 401(k) plan that accepts rollovers or to a Roth IRA.
- Designated Roth contributions are treated as elective contributions, so distribution may only be made upon termination of employment, death, disability, retirement, or if permitted under the plan, attainment of age 59½ or hardship. Although distributions are permitted for the above events, tax-free treatment is only provided to "qualified distributions". A qualified distribution is one that is made after age 59½, or on account of death or disability, and is made at least 5 years after the date the first designated Roth contribution was made. (referred to as the 5-year aging rule).
- A corrective distribution of excess contributions to the extent it represents designated Roth contributions would not be taxable upon distribution. However, a distribution of earnings on these excess contributions is taxable in the same manner as earnings allocable to a corrective distribution of pre-tax elective contributions.
- If designated Roth contributions are matched, a corrective distribution of excess aggregate contributions to the extent attributable to designated Roth contributions is not taxable. Earnings allocable to such a distribution would be taxed in the same manner as earnings allocable to other excess aggregate contributions.
- Designated Roth contributions are subject to IRC 401(a)(9) minimum required distribution rules.

Matching Contributions

- If designated Roth contributions are matched, the matching contributions will be made on a pre-tax basis and thus taxed upon distribution.

Reporting

- Designated Roth contributions will be reported with regular deferrals on Form W-2 and distributions will be reported on Form 1099-R.

Miscellaneous Provisions

- Designated Roth contributions are:
  - available for investment direction by the participant;
  - available for participant loans;
  - taken into account in determining the mandatory cash-out threshold;
  - subject to a qualified domestic relations order;
  - not subject to the 25% employer deduction limit; and
  - cannot be rolled over to a qualified plan (unless to another Roth 401(k)), IRA (unless to a Roth IRA), 403(b) or governmental 457 plan.

Open Issues Requiring IRS Guidance

- Model amendments for plan sponsors to use in implementing a Roth 401(k) plan;
- Rules governing the designation of contributions as Roth contributions;
- Application of the 5-year aging requirement for Roth IRAs to rollovers from a Roth IRA to a Roth 401(k);
- Rules that would permit plan administrators and plan sponsors to rely on participant representations (in the case of rollovers) with respect to the date when the first Roth 401(k) contribution was made;
- Compliance with the reporting requirements (Forms W-2 and 1099);
- Application of safe harbor IRC section 401(k)/(m) rules to designated Roth contributions;
- Confirmation that the ERISA anti-alienation protections would apply to Roth IRA assets rolled over to a Roth 401(k);

- Clarification on the application of the minimum distribution rules;
- Assets rolled over from a Roth IRA to a Roth 401(k) will be available for participant loans;
- Rules regarding tax implications of distributions within the 5-year aging period;
- Clarification on separate elections for rollovers, basis recovery as well as tax reporting;
- Ability of employee to rollover Roth IRA assets into a Roth 401(k) plan before becoming a participant; and
- The interaction between the automatic rollover IRA rules and the Roth IRA rules.

Advantages/Benefits of Roth 401(k)

- No income restrictions on who can contribute;
- Higher contributions and catch-up limits available when compared to a Roth IRA;
- Matching contributions available on a pre-tax basis;
- Tax-free distribution of earnings;
- If a participant's tax rate will be higher at time of distribution from the Roth 401(k) than at the time contributions were made, then contributing to a Roth 401(k) may be more advantageous than contributing pre-tax deferrals; and
- Depending on IRS guidance, rolled-over Roth IRA assets to a Roth 401(k) may be available for loans and may be eligible for ERISA anti-alienation protection.

Disadvantages/Challenges of Roth 401(k)

- Subject to ADP testing;
- Subject to IRC 402(g) limit;
- Separate accounting requires additional recordkeeping;
- Impact on administrative processes could be significant, i.e. tracking 5-year aging, changes to website, enrollment kits and participant statements, corrective distribution elections, rollover elections, tax reporting, tracking combined limits, tax basis, hardship withdrawals, loan administration, application of mandatory rollovers of small balances, etc.;
- Anyone considering establishing a Roth 401(k) account should weigh the cost of losing the tax benefits of pre-tax elective contributions against the benefits of a tax-free buildup, by looking at such factors as the assumed rate of return within the designated Roth account, the length of the accumulation period and the anticipated tax rate at time of distribution; and
- Communicating the benefits and tradeoffs to plan sponsors and employees could be a challenge.

Transamerica's Position on Roth 401(k)

With the release of these proposed regulations, Transamerica has begun exploring the option of adding a Roth 401(k) feature with our recordkeeping partners. As stated above, additional guidance will be required. Hopefully, the final regulations will resolve many of the outstanding issues. Transamerica will keep you informed of any new developments.