

# Legislative Alert

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## IRS issues additional Roth 401(k) and 403(b) guidance

As a follow-up to the final Roth 401(k) regulations, the Internal Revenue Service has now issued proposed guidance on the distribution and taxation rules for designated Roth contributions.

The proposed regulations address: taxation of distributions under Code Section 402A; provide additional guidance under Code Section 408A regarding rollovers to a Roth IRA arrangement; clarification as to the treatment of deferrals in excess of the Code Section 402(g) limit; and proposed amendments to the proposed 403(b) regulations adding Roth 403(b) to the proposed guidance.

### Designated Roth contributions

To review, a designated Roth contribution is an elective deferral to a 401(k) or 403(b) plan that a participant has irrevocably designated as a Roth contribution. To complete the designation as a Roth contribution, the employer must include the contribution in the participant's income taxable wages and the plan receiving the contribution must maintain a separate account or money source for the contributions.

### Taxation of qualified distributions

The proposed regulations separate the taxation of designated Roth distribution from the rules that apply to distributions of non-designated Roth contributions. Effectively, it is as if the Roth account is a separate contract from the rest of the plan.

If a distribution from a designated Roth account is a "qualified distribution", then it is not taxable. A "qualified distribution" is a distribution that occurs after a taxable five year period of participation and is: received on or after the date the employee attains age 59½, made after the employee's death, or is a result of the employee being disabled.

### Five year rule

The five year rule begins on the January 1 of the first year for which an employee makes a designated Roth contribution to the plan. The

regulations measure this five year period separately for each plan. Therefore, if an employee terminates employment with Employer A after having made a designated Roth contribution and begins employment with Employer B and again makes a designated Roth contribution, the employee will have two separate five year period requirements to meet before all of the employee's Roth distributions would be considered qualified.

An employee can avoid this by transferring his or her designated Roth Account from employer A's plan to employer B's plan in a direct rollover. In that case, the employee's participation in plan A would be added to his or her participation in Plan B to meet the five year rule.

### Certain distributions are never qualified distributions

Amounts that are not eligible rollover distributions under Treasury Regulation 1.402(c)-A4 are never qualified distributions. Accordingly, excess deferrals under Code Section 402(g), distributions to correct a violation of the average deferral percentage rules of Code Section 401(k) or the average contribution percentage rules of Code Section 401(m), deemed distributions of loans, the cost of life insurance protection, and dividend distributions of employer securities (unless reinvested) are never qualified distributions.

### Taxation of non-qualified distributions

If a distribution does not meet the qualified distribution rules the taxation of the distribution is consistent with the general rules under Code Section 72 with the Roth account being a separate contract for that purpose. For example, if an employee received a distribution of \$4,000 from a Roth account worth \$16,000 (immediately before the distribution) to which the employee contributed \$12,000, the distribution would consist of \$3,000 of basis and \$1,000 of taxable income ( $(12,000 \div 16,000 = 75\%)$ ).

## Rollover rules

Employers and employees will need to pay attention to some very specific rules with respect to rollovers:

- To rollover basis to another employer's plan, the employee must do so in a direct rollover. If the employee receives the distribution directly and later desires to accomplish a sixty day rollover the employee can only rollover the taxable portion to another employer's plan. A direct rollover, is a rollover, at the participant's election, that is made directly from one employer's 401(k) plan to another employer's 40(k) plan or from one employer's 403(b) plan to another employer's 403(b) plan.
- An employee can accomplish a complete sixty-day rollover by rolling both income and basis to a Roth IRA arrangement.
- When an employee rolls over a distribution to a Roth IRA arrangement, a new five year period will begin unless the employee has an existing Roth IRA for which they have already begun the clock on the five year period.

## Loans and defaulted loans

A plan may permit employees to borrow from their Roth accounts. If an employee does so, the loan must be repaid under the level amortization rules generally applicable to any loan. As noted above, any deemed distribution for failure to repay the loan will not be a qualified distribution.

## Hardship distributions

The Code restricts the amount of a hardship distribution to the cumulative deferrals less prior hardship distributions. A plan may permit an employee to take a hardship distribution from a Roth account, and a plan may further permit employees with both designated Roth contributions and pre-tax contributions to choose which account that they wish to receive the distribution from.

A hardship distribution from a Roth account will follow the same allocation of basis and income rules that apply to other taxable Roth distributions. In other words, suppose an employee has a Roth account with \$20,000 in basis and \$25,000 in value. In that case, a hardship distribution of \$10,000 will be 80%

(20,000 ÷ 25,000) return of basis and 20% taxable. Consistent with general tax rules, the employee does not have the ability to withdraw basis first.

## Alternate payees and beneficiaries

If an employee's Roth account is at some point allocated to an alternate payee or to one or more beneficiaries after death, then each alternate payee or beneficiary will have a separate Roth account for those funds. This is true even if the alternate payee or beneficiary is otherwise a participant in the plan. For example, suppose an employee dies with a Roth account and the employee's son and daughter (an employee in the same plan with her own Roth account) are the equal beneficiaries of the account. In this case, the plan will maintain three separate Roth accounts, one related to each beneficiary and one to the daughter for her own Roth contributions.

The proposed rules do not permit a disproportionate allocation of basis with respect to any alternate payee or beneficiary accounts. This would not seem to prevent a participant from naming a separate beneficiary for his or her Roth Account as opposed to providing that all beneficiaries share equally. Similarly, this rule does not seem to prevent a qualified domestic relations order from awarding the employee and the alternate payee specific interests in a Roth account versus the non-Roth accounts.

## Rollover accounts

If an employee rolls over Roth money from another plan, the separate nature of that Roth account will not transfer to the new plan. In that case, the employee has one Roth Account for purposes of these rules.

## Employer securities

The tax code provides the opportunity for special tax elections for employees who receive distributions of employer securities, and to the extent that such a distribution was not a qualified distribution the employee retains those election rights.

## Excess deferrals

Even though Roth contributions are not pre-tax they are subject to the deferral limits under Code Section 402(g). The proposed regulations retain the general rule that a participant may correct any excess deferral by distributing it with income (including gap period income) by April

15 of the following calendar year. The proposed regulations further provide that the result of a failure to correct the deferral is that the amount is includable in income (without adjustment for any basis) when distributed. This is the same double taxation that applies to the failure to correct a pre-tax excess deferral.

#### Recordkeeping rules

The sponsor of the plan offering Roth contributions, is responsible for tracking the employee's five years of participation and the employee's basis in the Roth account.

#### Distribution reporting

If an employee directly rolls a Roth account to another employer sponsored plan with designated Roth accounts, the transferring plan must inform the recipient plan what the first year of the five year period is and the amount of the employee basis in the Roth account. Alternatively, if applicable, the transferring plan can simply state that it is a qualified distribution. When an employee receives a distribution directly, the employee may request the employer to provide a statement containing similar information. In both cases, the statement is due within 30-days of the rollover or the employee's request.

#### Roth 403(b) plans

The proposed regulations also amend the proposed 403(b) plan regulations to add guidance for Roth 403(b) plans in similar fashion to the regulations already issued or proposed for Roth 401(k) plans.

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For more information about these regulations or any other issues affecting your plan, please call us at 1.866.774.3578 or by email at [rrhelpdesk@rsmi.com](mailto:rrhelpdesk@rsmi.com).