

# retirement

## plan news

MARCH/APRIL 2006

### Final Roth 401(k) Regulations Issued

On the afternoon of December 30, 2005, just under the wire, the IRS released final regulations for implementing the Roth 401(k). The effective date of the final regulations is January 3, 2006, and they apply to plans permitting Roth 401(k) deferrals beginning on or after January 1, 2006.

However, this was only one portion of the guidance that plan sponsors and administrators were expecting from the IRS. A "sample" amendment is still needed. And, the final regulations do not address tax recovery rules, leaving many questions about how Roth distributions will ultimately be taxed unanswered.

Here is a discussion of the final Roth 401(k) regulations. A discussion of tax recovery rules will be presented pending the release of guidance from the IRS.

**Plan Amendments.** The final regulations state that the deadline for adopting the plan amendment to add Roth 401(k) provisions is the last day of the plan year in which Roth 401(k) contributions are started. So calendar-year 401(k) plans that begin Roth contributions in 2006 must be amended by December 31, 2006.

Off-calendar-year plans are to be amended by the end of the plan year in which Roth 401(k) contributions begin. For example, an off-calendar-year plan with a March 31 year-end that starts Roth contributions on January 1, 2006, must be amended by March 31, 2006.

However, since the IRS has not yet issued the promised sample amendment, an off-calendar-year plan whose plan year ends before the sample amendment is

issued is permitted to rely on these regulations to implement the Roth contributions operationally. So, if Roth provisions are added to an off-calendar-year plan on January 1, 2006, and the plan year ends on January 31, 2006, unless the sample amendment has been issued by that time, complying with the Roth regulations will be satisfactory. Once the sample amendment is issued, the plan must adopt it by the last day of the current plan year.

#### **Designated Roth Contributions.**

The new contributions must meet several requirements. They are elective contributions under a 401(k) plan that are:

- Irrevocably designated by the participant as Roth contributions (made in lieu of all or a portion of the participant's pretax elective deferrals).
- Subject to applicable income-tax withholding requirements and included in the participant's gross income.



- Maintained in the plan in a separate account. Note: This does not have to be an actual separate account requiring the separation of trust investments, but records for the Roth account must be separately kept at all times.

**Same Rules Apply.** Roth contributions must satisfy the same rules that apply to traditional pretax elective deferrals.

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# Final Roth 401(k) Regulations Issued *(Continued from page 1)*



Specifically, Roth contributions are nonforfeitable, subject to the actual deferral percentage (ADP) test, may be treated as catch-up contributions, are available for participant loans (if plan loans are permitted), and are subject to required minimum distribution (RMD) rules. An employee must have the effective opportunity to make (or change) an election to make designated Roth contributions at least once during each plan year.

*Comment:* ERISA 404(c) rules, which permit participants to take responsibility for their own investment returns, apply to Roth contributions. Thus, a plan choosing to comply with 404(c) must permit elections at least quarterly.

**Roth 401(k) Versus Roth IRA.** There are several significant differences between Roth 401(k) contributions and Roth IRA contributions.

- Unlike Roth IRAs, which have an income limit, plan participants may make Roth 401(k) contributions without regard to the amount of their adjusted gross income (AGI).
- Plan participants may not convert existing pretax elective deferrals to Roth 401(k) contributions. Tax-deductible IRA contributions may be converted to Roth IRA contributions.
- Distribution ordering rules, which

apply to Roth IRAs, do not apply to Roth 401(k)s.

- Roth 401(k) contributions are subject to required minimum distribution rules. Roth IRA contributions are not.

## **Stand-alone Roth Plans Not**

**Permitted.** The final regulations confirm that Roth 401(k) provisions are only permitted as part of a 401(k) plan that provides for pretax elective contributions. Thus, a plan may not be designed to offer only the after-tax Roth 401(k) contribution option.

**Separate Accounting.** Roth contributions must be accounted for separately. The requirements are:

- Roth contributions must be credited and debited to a designated Roth account.
- Gains, losses, and other credits or charges to the designated Roth account must be separately allocated on a reasonable and consistent basis.
- Each participant's total after-tax account must accurately reflect both Roth contributions and distributions.
- Separate accounting is required from the time a designated Roth contribution is first made to the plan until the Roth account is completely distributed.
- Rollover contributions to a designated Roth account are only permitted from another designated Roth 401(k) account.
- Matching contributions may be made on Roth deferrals, but the match may not be allocated to the Roth account. Likewise, forfeitures may not be allocated to a Roth account.

**ADP/ACP Correction Methods.** If a highly compensated employee (HCE) has made both Roth and pretax contributions in the same year, and the plan fails ADP testing, the regulations permit the HCE to elect whether refunds of excess contributions are treated as pretax, Roth, or a

combination of the two. Alternatively, the employer or document provider may design the plan by choosing one of the correction methods instead of allowing the participant to choose.

Although the distribution of excess Roth contributions is not a taxable event, the income allocable to a corrective distribution of the Roth excess contribution is taxable. Similar rules exist for the ACP test. The plan document must reflect the extent to which a plan permits employees to determine the "character" of excess or excess aggregate contributions. It will be clearer how to best address this issue once the IRS issues the sample amendment and the tax recovery rules.

**Automatic Enrollment.** The plan document must specify the extent to which default contributions are to be treated as pretax elective or designated Roth contributions. If an employer designates the automatic enrollment deferral as a Roth contribution, unless an employee makes an election replacing the default, participant contributions are irrevocably Roth contributions.

**Direct Rollovers.** A direct rollover from a Roth account may be made only to another designated Roth 401(k) account or to a Roth IRA. For direct rollover purposes, the designated Roth account is treated as separate from the rest of the 401(k) plan. Thus, if the participant's Roth account is less than \$200, the plan is not required to offer a direct rollover of the Roth account or to apply the automatic rollover provisions in the event of an involuntary cash-out.

**EGTRRA Sunset.** If the EGTRRA sunset provision for the Roth 401(k) is not repealed before December 31, 2010, and the Roth 401(k) is eliminated from the tax code, the IRS will need to issue guidance to clarify the situation at that time. ❖

# Katrina Distributions Impact Plans Nationwide

In addition to providing direct relief to plan participants affected by Hurricane Katrina by easing the terms of hardship withdrawals and plan loans, IRS guidance allows plan participants with relatives who lived or worked in the area hit by Katrina to take hardship withdrawals or loans from qualified plans (other than defined benefit and money purchase plans) on the victims' behalf until March 31, 2006. Here is an overview of the different ways plans nationwide may be affected.

The withdrawal or loan must be for a lineal ascendant or descendant, dependent, or spouse who had a principal place of residence or employment in counties or parishes designated as eligible for "individual taxpayer relief" by the Federal Emergency Management Agency (FEMA) following Katrina.

No equivalent relief was provided for individuals solely affected by Hurricanes Rita or Wilma, or on behalf of individuals employed or residing in counties or parishes eligible for "public assistance" (under the Federal Emergency Management Agency's designation), such as those in the state of Florida.

**Hardship Withdrawals.** In processing hardship withdrawals, plan administrators may rely on an employee's representation of the distribution amount needed. And, administrators may disregard otherwise applicable administrative procedures as long as:

- (1) A good faith effort to comply with such requirements is made, and
- (2) A reasonable effort to collect any foregone documentation is undertaken as soon as possible after the withdrawal.

Further, 401(k) plans do not have to follow the safe harbor hardship distribution rules when processing Katrina-related withdrawals. Plans that do not permit hardship distributions may make them provided that plan documents are appropriately amended to add hardship provisions by the last day of the 2006 plan year. This special relief applies to hardship dis-



tributions made on or after August 29, 2005, but not later than March 31, 2006. They may be taken only by employees and former employees (and their relatives as previously described) whose principal place of residence or employment at the time of Katrina was located in specific counties and parishes in Alabama, Louisiana, or Mississippi.

**Plan Loans.** Plan loans may also be made for needs arising from Hurricane Katrina. The same waivers of procedural and legal requirements that apply to hardship distributions also apply to plan loans. As with hardship withdrawals, the expanded plan loan relief is applicable only in areas that have been determined as eligible for "individual" assistance.

**The KETRA "Catch."** There are some inconsistencies between the expansive IRS guidance and the provisions of the Katrina Emergency Tax Relief Act (KETRA) enacted September 23, 2005. While the IRS allows family members outside the Katrina disaster area to take distributions and loans on behalf of family members affected by Katrina, the relief included in KETRA — a waiver of the 10% penalty on early distributions, increased plan loan limits, and the ability to repay Katrina-related distributions or spread applicable federal tax payments over three years — was not extended to those family members.

**Update:** The passage in late December of the Gulf Opportunity Zone Act (GOZA) extends KETRA tax relief provisions to victims of Hurricanes Rita and Wilma. ❖

# recent developments

■ **2005 Cumulative List.** As part of the new restatement process, the IRS will issue a cumulative list of changes in plan qualification requirements every year. The list just issued is predominately for individually designed plans (IDPs) in restatement cycle A (plan sponsors whose employer identification number ends in 1 or 6). These plans are to be rewritten using the guidelines in the 2005 cumulative list and submitted to the IRS by January 31, 2007.

■ **Court Case.** In *Osborn vs. Knights of Columbus*, 2005 U.S. Dist. Lexis 29069 (N.D. Ohio 2005), the participant requested plan documents, including an SPD. The request was sent to the employer's headquarters where it was received and forwarded to the employer's legal counsel. From

there, the request was forwarded to the proper department. The employer claimed that the plan administrator had not received the request. The court disagreed. It held that the employer *is* the plan administrator and had received the request. The employer was fined the maximum amount (at the time) of \$110 for each day the documents were late. It is important for employers to realize that in most instances, the employer who sponsors the plan is the plan administrator and has a number of responsibilities, including providing a variety of plan documents when requested by participants. This case follows a similar one reported recently (*Lowe vs. McGraw-Hill*) and serves to underscore the importance of provid-

ing employees with requested plan documents in a timely manner. Responses should be provided within 30 days.

■ **Did You Know?** In 2005, more than 48 million Americans received approximately \$518 billion in Social Security benefits. In a typical month, 30 million retired workers received \$29 billion (an average of about \$959 per month). 3.1 million dependents of retired workers received \$1.4 billion in benefits. 6.4 million disabled workers and 1.7 million of their dependents received a total of \$6.2 billion (for a monthly average of \$897). Survivors' benefits were paid to 6.6 million Americans at an average of \$925 a month for a total of \$5.5 billion. ❖

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