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MARCH 2, 2005

## MEMORANDUM

***Re: Roth Contributions – Proposed Regulations Issued***

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) added a new Internal Revenue Code section 402A permitting a plan qualifying under Code section 401(k) to offer participants a choice of making after-tax employee contributions that produce the same tax consequences at the time of contribution and distribution as a Roth IRA. This new alternative is called a "qualified Roth contribution program." Proposed regulations dealing with the Roth 401(k) requirements are published in today's *Federal Register*.

The tax consequences of a qualified Roth contribution program are: (1) there is no tax benefit to the participant at the time of contribution (*i.e.*, unlike 401(k) salary reduction contributions, which are excluded from taxable compensation, Roth Savings are fully taxed just like after-tax associate contributions) and (2) in the case of distributions made from the plan after a period of five years from the first Roth contributions to the Plan or to his own Roth IRA by an individual, there will be no taxation of a distribution of the contributions and associated investment increment (unlike ordinary after-tax participant contributions where the investment increment would be taxed as ordinary income at distribution, and unlike 401(k) salary reduction contributions, which incur tax on the entire distribution).

In our view, the Roth contribution alternative is potentially a highly attractive design feature and we believe that most large 401(k) plan sponsors will decide to add this feature to their plans for 2006.

## **Basic Rules**

The significant rules that would apply to a Roth Savings alternative, if added to the Plan, are the following:

- Roth contributions are permitted only for periods after the end of calendar year 2005. Unless legislatively extended, the rules permitting Roth contributions will be automatically repealed for periods after calendar year 2010 by the sunset provision that applies to most of the tax changes enacted by EGTRRA.

- Roth contributions are subject to the same dollar limit that applies to 401(k) salary reduction contributions ($15,000 for 2006, to be indexed for cost-of-living increases for years after 2006) and share this limit, *i.e.*, the combination of Roth Savings and 401(k) salary reduction amounts cannot exceed the applicable limit. The applicable limit is not reduced by contributions that a participant may make to his own Roth IRA.

- For nondiscrimination testing purposes, Roth Savings will be treated under the ADP test along with (or in lieu of) 401(k) salary reduction contributions rather than under the ACP test for after-tax and matching contributions. Note that lower-paid participants who switch from 401(k) salary reduction amounts to Roth Savings may be expected in some cases to lower their plan contribution percentage so as to achieve the same take-home result, thus potentially affecting the ADP testing.

- The right to make Roth 401(k) contributions is a right or feature that is subject to nondiscrimination testing.

- For withdrawal purposes, Roth 401(k) contributions would be restricted like 401(k) salary reduction contributions, distribution being permitted only after termination from employment, death, disability, or plan termination. Distributions could also be permitted under the section 401(k) hardship rules.

- If the Plan provides plan loans to participants, loans could be permitted from Roth contributions in the same way as other accounts under the Plan and subject to the same combined limits.

## **Proposed Regulations**

The proposed regulations address a number of key points that will affect plan drafting and administration of Roth 401(k) contributions. These include the following:

- The plan must provide for Roth 401(k) contributions, which presumably means that the Roth 401(k) contribution feature must be described in a plan provision before any such contributions are made. Roth contributions must be designated irrevocably as such at the time the cash or deferred election is made and they must be treated as taxable for payroll tax purposes at the time they otherwise would have been paid to the employee.

- Roth 401(k) contributions must be accounted for separately from other plan contributions and gains and losses must be credited to the Roth contributions on a "reasonable and consistent basis." No forfeitures may be allocated to the Roth contribution account.

- Roth contributions are subject to the minimum distribution rules of Code section 401(a)(9).

- If a plan fails the ADP test for a year and must correct the ADP failure, HCEs with both regular 401(k) contributions and Roth 401(k) contributions may designate which type of contributions are subject to the correction step.

- A participant may designate whether a particular distribution is from the Roth 401(k) account or from another plan account provided the plan document permits such a designation.

- The direct rollover provisions in the plan must provide that Roth 401(k) contributions may be rolled over only to another plan with Roth 401(k) contributions.

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