

CLIENT ACTION BULLETIN

July 12, 2007

CAB 07-08

IRS Issues Further Roth 401(k)/403(b) Guidance

SUMMARY The IRS has provided further guidance in the form of final regulations on rules relating to Roth 401(k) and Roth 403(b) accounts (first made available in 2006).

These final regulations reflect changes under the Pension Protection Act of 2006, including the elimination of the 2011 sunset originally applicable to Roth 401(k) arrangements. This new guidance explains how the five-year taxable period is measured after a rollover of the account, thereby determining whether the distribution is qualified, and ultimately whether account earnings are taxed. It also clarifies the tax basis for partial distributions. These additional regulations became effective April 30, 2007 and are applicable for tax years beginning January 1, 2007 and thereafter.

DISCUSSION **Roth 401(k)/403(b) Basics**

Beginning in 2006, 401(k) and 403(b) plans could be amended to accept post-tax contributions into a separate designated Roth account. Contributions would be subject to the annual elective deferral limit (\$15,500 for 2007, with additional \$5,000 catch-up if age 50 or over), reduced for any pre-tax contributions. What set these post-tax accounts apart, of course, was this: investment earnings could be paid out tax free, if certain qualifying conditions were met.

Qualifying conditions include the timing of when the first post-tax contribution was made to the designated Roth account and whether a qualifying event has occurred. Specifically, distributions avoid any taxation on investment earnings and contributions:

- ∞ after the end of the fourth taxable year following the tax year the first contribution was made (“five-year taxable period”)
- ∞ **and** upon one of the following events:
 - ✓ attainment of age 59 ½;
 - ✓ death of the participant; or
 - ✓ disability.

It is important to understand that the qualification clock starts with the tax year that the first dollar is contributed to the designated Roth account and applies to the entire account when determining qualification in conjunction with the qualifying event.

Thus, participants likely to benefit from these accounts should start the qualification clock immediately by making a contribution to their employer’s designated Roth account. Similarly, a reemployed veteran who has an opportunity to make retroactive contributions into a designated Roth account would be best served by designating a contribution for the earliest tax year available (but not before the tax year in which the plan first made the designated Roth accounts available).

Contributions made but fully refunded (i.e., withdrawals of automatic enrollment contributions or 100% of Roth contributions refunded as excess deferrals) would not count towards the initial start date for the five-taxable-year period.

If allowed by the plan sponsor, participants who receive excess contribution refunds due to failed nondiscrimination testing could instruct their employers to refund the Roth contributions first, before dipping into any pre-tax deferrals, in order to avoid or minimize the taxes on such excess contributions.

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One possible strategy in refunding excess contributions where both pre-tax and Roth 401(k) contributions exist (and the entire contribution is not deemed excessive) is to try to retain at least \$1 of the Roth 401(k) contribution in order to get the qualification clock started (and assuming an earlier year's Roth contribution has not been made).

To Roth or Not to Roth

A qualifying Roth account can be beneficial to participants in many different economic situations. The biggest issue for a participant is trying to estimate their tax level in retirement relative to their tax rates today. Those expecting an increase in future taxes via migration to a higher tax bracket or anticipation of an overall tax rate increase by the government would be advised to take advantage of these accounts. If a participant's expected tax rate in retirement were to remain unchanged from the rate they are paying today, there will still be advantages to having Roth 401(k) savings to control one's taxable income stream in retirement. Employees phasing into retirement with partial employment may find withdrawals from these accounts advantageous in minimizing their taxable income for a given employment year.

These accounts will also provide flexibility to lower-income participants who want to minimize the tax impact on their Social Security benefit. Qualified distributions from designated Roth accounts do not count towards adjusted gross income. When adjusted gross income for Social Security beneficiaries rises above \$25,000 for single tax payers and \$32,000 for married filers, it triggers the taxation of their Social Security benefits. As adjusted gross income climbs higher, as much as 85% of the Social Security benefit can be taxed. These income thresholds that trigger taxation of Social Security benefits are not indexed.

Roth Rollovers

Departing participants can roll over their designated Roth accounts into their new employer's plan only if the new employer offers the Roth account feature in the plan and the rollover is never touched by the participant (i.e. no 60-day rule permitted for a participant pass-through). For direct plan-to-plan rollovers of designated Roth accounts, the five-year taxable period is based upon the original contribution's tax year and any future contributions with the new employer get "time stamped" with the start date of the rollover's original contribution. Otherwise, without the rollover, the qualifying period starts fresh with any Roth contributions made to a new plan. A 401(k) Roth account can also be rolled over into a 403(b) designated Roth account.

Alternatively, a departing participant could roll the Roth account into a Roth IRA, where the 60-day rollover rule would be available. The investment basis of the rollover depends on whether the rollover would have been a qualified distribution when the account was distributed. If the rollover would have been a qualified distribution, the investment basis in the Roth IRA is the entire amount. If not a qualified distribution, then the basis excludes investment earnings on the account at time of rollover. If the Roth rollover account is less than the sum of the original after-tax contributions (i.e. net investment losses), the investment basis in the rollover is deemed to be the sum of the contributions and not the lesser account balance.

A Roth account to Roth-IRA rollover could be utilized to avoid the minimum distribution rules as a participant reaches age 70 ½, extending the tax-free buildup of the participant's investments in retirement. If only part of the Roth account is rolled over to a Roth IRA, the investment income is assumed to be received by the Roth IRA first.

A quirky penalty for Roth to Roth IRA rollovers is that the five-year taxable period qualification clock starts over for the receiving Roth IRA (unless a contribution was made to the receiving Roth IRA account in an earlier tax year). Thus, participants may want to either roll over their Roth accounts to an earlier established Roth IRA account or commence establishment of a Roth IRA account several years before retirement (presumably via an in-service post-age 59 ½ qualified distribution of their Roth Account, if their income precludes them from establishing a Roth IRA independently).

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While distributions from qualified pre-tax accounts may be rolled over and converted to Roth IRAs for certain income thresholds (earning less than \$100,000 and not married or filing separately), no similar allowance is made for qualified pre-tax accounts being converted into a designated Roth account within the 401(k) or 403(b) plan. For surviving spouses and alternate payees, the participant's Roth account (or portion thereof) can be rolled over to the surviving spouse's or alternate payee's designated Roth account (assuming their employer offers such accounts within the plan). The qualifying distribution for any beneficiary or alternate payee is based on the age and status of the participant at the time of distribution. The automatic \$1,000 cash-out threshold may be applied separately to the Roth account versus other pre-tax monies.

As a Reminder: Requirements for Roth Accounts in 401(k)/403(b) Plans

A plan sponsor that wants to offer participants the ability to make Roth 401(k)/403(b) contributions must first amend the plan to provide for such contributions. The Roth contributions and earnings thereon must be accounted for separately in the recordkeeping system. Although Roth 401(k)/403(b) contributions may be matched, employer contributions, such as matching, must be made on a pre-tax basis and not as Roth contributions; the Roth portion may, however, receive rollovers from other Roth 401(k) accounts.

Roth 401(k) contributions are subject to the same rules that apply to elective deferrals, including immediate vesting and the restriction on distributions until a distributable event has occurred. Distributions from the Roth 401(k) account prior to five years are taxable on the portion of the distribution representing earnings on the Roth contributions, while partial distributions are taxed on a pro-rata basis (i.e., the investment basis is not deemed to come out first).

Roth contributions are treated as elective deferrals for purposes of the actual deferral percentage (ADP) test. A self-employed individual can only establish a Roth contribution by not taking a deduction for the contribution.

If a participant's deferrals exceed the deferral limit (\$15,500 in 2007), the normal rules for returning these deferrals apply. If a designated Roth contribution excess deferral is returned after April 15, it is taxable in the year it is returned, as well as the year in which it was made. Thus, plans must be carefully designed and administered to prevent this double taxation.

Administration:

A plan sponsor adopting a Roth 401(k) feature must:

- amend the plan by the end of the plan year to allow participants to designate a portion of their elective deferrals as Roth contributions, while at the same time specifying the deferral amount that may be so designated;
- keep track of the investment basis of the Roth contributions and the initial year of contribution for each participant and communicate that information upon employee request or to the new administrator upon the account's rollover (no later than 30 days);
- designate the portion of any automatic deferral under automatic enrollment that will be treated as a Roth contribution;
- establish a separate account for the Roth contributions and allocate investment earnings to that account, while prohibiting the receipt of any forfeitures or employer matching contributions to the Roth 401(k) account; and,
- ensure that any direct rollovers of Roth 401(k) contributions are made only to a Roth IRA or another Roth 401(k) plan.

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The new IRS regulations allow plan sponsors to offer employees the option of making after-tax contributions to a 401(k) plan by establishing the Roth account.

The principal advantage of this feature is to provide participants more flexibility in controlling their taxable income in retirement, the ability to prepay the taxes on their retirement account during their working years, and the potential to lower overall taxes paid on combined contributions and investment earnings. These accounts also provide an opportunity to defer the payment of taxes longer via a rollover into a Roth IRA.

The principal disadvantage may be an increased administrative cost due to the need to establish separate accounts for such contributions and communicate this information to the designated administrative recipient of a Roth account rollover. It will also involve more participant communications and education, especially if individualized financial planning and advice is sought.

Nonetheless, the Roth 401(k) feature could make the 401(k) plan more attractive to employees, because it gives them the ability to prepay taxes during their working years and perhaps minimize the overall taxes associated with these accounts.

For additional information about the IRS's guidance, or assistance adopting a Roth 401(k) plan, please contact your Milliman consultant.