403(b) Perspectives

Insights into the Administration of §403(b) Tax-Sheltered Arrangements

WINTER 2006

Final 401(k) Roth Regulations Issued

The Roth 401(k) was created by the Economic Growth and Tax Recovery Reconciliation Act of 2001 (EGTRRA), which added Section 402A to the Internal Revenue Code. The IRS is issuing the rules on the Roth 401(k) in three parts: first, final regulations on administrative issues, which were proposed in March, 2005; second, proposed tax recovery rules; and third, a "sample" amendment to incorporate the Roth 401(k) provisions into the plan.

On the afternoon of December 30, 2005, the IRS released the Roth 401(k) final regulation portion. The effective date of the final regulations is January 3, 2006, and they will apply for plans permitting Roth 401(k) deferrals beginning on or after January 1, 2006. This article describes the Roth 401(k) regulations. However, because the final regulations left the distribution and taxation rules to a subsequent release, some questions remain unanswered as to how Roth distributions will ultimately be taxed.

Throughout the final 401(k) regulations, there was no mention of their applicability to 403(b) designated Roth accounts. However, the IRS did address the 403(b) Roth accounts briefly in the special edition of the *Employee Plans News* issued January 12, 2006 in which the IRS stated:

"Similar rules will apply to designated Roth contributions available under 403(b) plans sponsored by tax-exempt organizations and public schools."

Therefore, we present below the overview of the Roth 401(k) regulation. When the IRS issues the rest of the Roth 401(k) guidance and when the IRS issues any specific guidance on anything that is applied differently to 403(b) plans Roth account, we will present it. In the meantime, it is clear that designated Roth 403(b) contributions may be made to a separate account within a 403(b) arrangement, provided the arrangement is amended by the end of the plan year in which the designated Roth contributions were started. See the plan amendments section below.

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)

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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. Thus, if Roth provisions are added to an off-calendar-year plan as of January 1, 2006, and the plan year ends on January 31, 2006, unless the sample amendment has been issued before January 31, 2006, 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.

NOTE: Since the IRS permits plans to operate Roth designated accounts before the IRS sample amendment is adopted; MHCO will not be issuing a model amendment. We will wait for the IRS sample amendment. MHCO will reach clients via a broadcast e-mail as soon as the sample amendment is available.

Roth 401(k) Versus Roth IRA

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

1. 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).
2. Plan participants may not convert existing pretax elective deferrals to Roth 401(k) contributions. Traditional tax-deductible IRA contributions may be converted to Roth IRA contributions.
3. Distribution ordering rules, which apply to Roth IRAs, do not seem to apply to Roth 401(k)s. (More details are expected on this subject when the tax recovery rules are proposed and then finalized.)
4. Roth 401(k) contributions are subject to required minimum distribution (RMD) rules. Roth IRA contributions are not.

Designated Roth Contributions

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

1. Irrevocably designated by the participant as Roth contributions (made in lieu of all or a portion of the participant's pretax elective deferrals).
2. Subject to applicable income-tax withholding requirements and included in the participant's gross income.
3. Maintained in the plan in a separate account. Note: this does not have to be a "real" separate account requiring the separation of the trust investments, but the amounts attributed to the designated Roth account must be recordkept separately at all times.

Same Rules Apply

Roth contributions must satisfy the same rules that apply to traditional pretax elective deferrals. 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), are subject to withdrawal restrictions, and are subject to 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 permitting participants, rather than their employers, to be responsible for their own investment returns apply to Roth contributions. Thus, a plan choosing to comply with 404(c) must permit elections at least quarterly.

Separate Accounting Rules

The Roth separate account requirements are as follows:

1. Designated Roth contributions must be credited and debited to a designated Roth account.
2. Gains, losses and other credits or charges to the designated Roth account must be separately allocated on a reasonable and consistent basis.
3. Each participant's total after-tax account is to be accurately kept, reflecting Roth contributions and subtracting Roth distributions.
4. Separate accounting is required from the time a designated Roth contribution is first made to the plan until the Roth account is completely distributed.
5. Rollover contributions to the designated Roth account are only permitted from Roth 403(b) designated accounts.
6. Matching contributions may be made on the Roth deferrals, but the match may not be allocated to the Roth account. Likewise, forfeitures may not be allocated to a Roth account.

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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.

Automatic Enrollment

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

Direct Rollovers from Roth 401(k) Accounts

A direct rollover from a Roth account may be made only to another designated Roth 403(b) 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. This could clearly complicate administration, where the regular pretax amounts *are* subject to the automatic rollover provisions.

ADP/ACP Correction Methods

If a highly compensated employee (HCE) has made both Roth and pretax contributions in the same plan 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 taxable, the income allocable to a corrective distribution of the Roth excess contributions 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 contributions and excess aggregate contributions. Once the IRS sample amendment and tax recovery rules are issued, it will be clearer how to best address this issue.

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. ■

How Much May Be Contributed to a 403(b) in the 2006 Year?

402(g) Limits Set by Statute; 415 Limit Cost-of-Living Adjusted

For an individual in a 403(b) plan, the deferral limit has increased in 2006 to $15,000. [Check out our Cost-of-Living Chart for 2006 at *www.mhco.com*]. In addition, if the employer is contributing, the maximum that can be contributed is the lesser of 100% of earned income or $44,000 for 2006. Thus, in the case where an employee contributes the maximum of $15,000, the employer contribution can go as high as $29,000, if the employee earns $44,000 or more. In addition, if the individual will attain age 50 or older during the year, a catch up contribution of $5,000 is also allowed.

The 15 Years of Service Catch-up Contribution

There is also a special catch-up contribution under Code Section 402(g)(8) for employees with more than 15 years of service with an educational, hospital, home health care or church organization. The additional contribution is the lesser of $3,000 or $15,000 minus previous contributions under (g)(8) or $5,000 multiplied by years of service minus previous deferrals.

For example, Michael Johnson, age 45, worked for 18 years for the same 501(c)(3) charitable employer. During that time, Jonathan deferred a total of $56,000 into the employer's 403(b) plan, and in the last 3 years has deferred a total of

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How Much May Be Contributed to a 403(b) in the 2006 Year?

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$9,000 above the elective deferral limit. What would Jonathan's catch-up amount be? Following the formula, the catch-up is the lesser of:

a. $3,000 or
b. $15,000 less $9,000 = $6,000
c. $5,000 x 18 = $90,000 - $56,000 = $34,000

No age-50 requirement is applicable. However, if you are age 50 or over, there is a coordination of the two types of catch-up that must be carefully done.

Coordination of the Two Types of Catch-up Contributions (15 Years of Service Catch-up (402(g)(8) and the EGTRRA Catch-up 414(v))

Now that there are two types of catch-up, there are also rules for how they are to interact. Specifically, the $3,000 is to be used first. If this is not understood in advance, the 414(v) catch-up could be lost. If a participant is over age 50 and has over 15 years and has not yet used the catch-up due to the 15 years of service, the 15-year catch-up must be used first.

For example, if an individual over age 50 with 15 years of service made an elective deferral contribution of $17,000. The first $15,000 would exhaust the 402(g) limit. However, the $2,000 above the 402(g) limit would be considered a catch-up towards 15 years of service $15,000 catch-up amount (assuming it had not already been used up). Thus, the individual would not have used the 414(v) $2,000 catch-up towards the $5,000 catch-up limit of 2006, and it could never be made up in a future year. However, if the participant wanted, he or she could have put in the $3,000 catch-up towards the 15 years of service catch-up and an additional $5,000 for the 414(v) catch-up for a total of $23,000 in 2006 ($15,000 + $3,000 +$5,000). In other words, the first dollars contributed above the base elective deferral limit are deemed to be Section 402(g)(8), 15 years of service amounts and not the annual 414(v) over age 50 catch-up contribution limit.

The rule of thumb to keep in mind is that even though the individual is over age 50, the 15 years of service catch-up is required to be used before the 414(v) catch-up can be used.

Up to 5 years of Post-Retirement Contributions based on includible compensation from last year of work prior to retirement.

EGTRRA Section 632(a)(2)(C) (and clarified by JCWAA 411(p)) allows for contributions to a 403(b) annuity to be made for an employee for up to five years after retirement based on includible compensation from the last year of service before retirement. Includible compensation for purposes of the 403(b) contribution is the amount of compensation received from the employer and includible in the employee's gross income for the most recent period (ending not later than the close of the employee's tax year) that can be counted as a full year of service. This compensation may not precede the taxable year by more than five years. Finally, includible compensation may not include any amount contributed by the employer to the employee's 403(b) annuity. This significant change is a major advantage available to a 403(b) participant, because it can allow for an employee to arrange for the employer to contribute up to $220,000 (5 x $44,000, as adjusted) to the plan after they terminate employment. For example, for school districts wishing to buy out the contract of an administrator, this provides added flexibility for both parties. The district gets to pay out amounts over time and the employee gets contributions to a tax-favored arrangement.

JCWAA also clarified that 403(b) contributions are subject to 415 limits for the year in which the contributions are made — regardless of whether the contributions are vested or not at the time they are contributed.

Deemed IRA

This option for a 403(b) would require the incorporation of model IRA language to the 403(b). If this is adopted into the plan, the employees may contribute up to the IRA limit to a deemed IRA account. Deemed IRAs are possible in a 403(b). The deemed IRA portion of the qualified plan must follow the regular IRA rules that require the Trustee or Custodian of IRA assets to be a bank or IRS-approved Trustee or Custodian. Therefore, deemed IRAs cannot be self-trusteed.

Designated Roth 403(b) Account.

See the separate article on the designated Roth 401(k). ■

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