

## FAQs REGARDING DESIGNATED ROTH ACCOUNTS

These frequently asked questions and answers are provided for general information only and should not be cited as any type of legal authority. They are designed to provide the user with information required to respond to general inquiries. Due to the uniqueness and complexities of Federal tax law, it is imperative to ensure a full understanding of the specific question presented, and to perform the requisite research to ensure a correct response is provided. These FAQ's are based on the final regulations, Designated Roth Contributions to Cash or Deferred Arrangements under Section 401(k) released January 3, 2006 and final regulations, Designated Roth Account under Section 402A released April 30, 2007.

*Note: Designated Roth contributions are allowed in 401(k) plans and 403(b) plans but not in SARSEPs or SIMPLE IRA plans.*

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## **GENERAL QUESTIONS REGARDING DESIGNATED ROTH ACCOUNTS IN RETIREMENT PLANS**

### **1. What is a Roth 401(k) or Roth 403(b)? Is it a new type of plan?**

No, it is not a new type of plan. Designated Roth contributions are a new type of contribution that can be accepted by new or existing 401(k) or 403(b) plans. This feature is permitted under a Code section added by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), effective for years beginning on or after January 1, 2006. If a plan adopts this feature, employees can designate some or all of their elective contributions as designated Roth contributions, (which are included in gross income) rather than traditional, pre-tax elective contributions. So, starting in 2006, elective contributions come in two types: traditional, pre-tax elective contributions (elective contributions are also referred to as elective deferrals) and designated Roth contributions.

### **2. Can my employer start making designated Roth contributions to my designated Roth account as of January 1, 2006?**

Legislation permits designated Roth contributions to be made under 401(k) or 403(b) plans after December 31, 2005; HOWEVER, these plans must be properly amended for this feature by the end of the plan year in which the Roth contributions are first effective.

## **DESIGNATED ROTH CONTRIBUTIONS**

### **1. What is a designated Roth contribution?**

A designated Roth contribution is an elective deferral to a section 401(k) or 403(b) plan that has been designated irrevocably by an employee as not excludable from the employee's gross income and to be deposited into a designated Roth account under the plan. Thus, the contribution is treated by the employer as includible in the employee's gross income at the time the employee would have received the amount in cash if the employee had not made the election (hence subject to all applicable wage withholding requirements). Designated Roth contributions are allowed in 401(k) plans and 403(b) plans but not in SARSEPs or SIMPLE IRA plans.

### **2. Can I make both pre-tax elective and designated Roth contributions in the same year?**

Yes, you can make contributions to both a designated Roth account and a traditional, pre-tax account in the same year in any proportion you choose. However, the combined amount contributed in any one year is limited by the 402(g) limit - \$15,000 for 2006 (\$15,500 in 2007 plus an additional \$5,000 in catch-up contributions if age 50 or older).

### **3. Are there any limits as to how much I may contribute to my designated Roth account?**

Yes, the combined amount contributed to all designated Roth accounts and traditional, pre-tax accounts in any one year for any individual is limited by the 402(g) limit - \$15,000 for 2006 (\$15,500 in 2007 plus an additional \$5,000 in catch-up contributions if age 50 or older).

**4. Can my age-50 catch-up contributions be made as a designated Roth contribution to my designated Roth account?**

Yes.

**5. Must I make the election to make designated Roth contributions at the beginning of the year?**

The rules regarding frequency of elections apply in the same manner to both pre-tax elective contributions and designated Roth contributions and must be specified under the plan. Thus, an employee must have an effective opportunity to make (or change) an election to make designated Roth contributions at least once during each plan year. A Roth election must be in place before any money can be placed in a designated Roth account.

**6. Do the same income restrictions that apply to Roth IRAs apply to designated Roth contributions?**

No, there are no limits on income in determining if designated Roth contributions can be made. Of course, you have to have salary from which to make any 401(k) or 403(b) deferrals.

**7. Can my employer make matching contributions on my designated Roth contributions? Can the matching contributions be allocated to my designated Roth account?**

The employer can make matching contributions on designated Roth contributions. However, only an employee's designated Roth contributions can be allocated to designated Roth accounts. The matching contributions made on account of designated Roth contributions must be allocated to a pre-tax account, just as matching contributions on traditional, pre-tax elective contributions are.

**8. Can plan forfeitures be placed into my designated Roth account?**

No amounts other than designated Roth contributions and rollover contributions (and earnings on such contributions) are permitted to be allocated to a designated Roth account. Therefore, forfeitures, matching or any other employer contributions may not be allocated to the designated Roth account.

**9. If I start making designated Roth contributions at the beginning of the year and later change my mind and want them treated as pre-tax elective contributions, can they be re-characterized and transferred from the designated Roth account to the traditional, pre-tax account?**

No, the election to make designated Roth contributions is irrevocable. Once they are designated as Roth contributions, they cannot later be changed to pre-tax elective contributions.

**10. Can my plan offer only designated Roth contributions?**

No, in order to provide for designated Roth contributions, a 401(k) or 403(b) plan must also offer pre-tax elective contributions.

**11. Can my plan automatically enroll me into making designated Roth contributions if I fail to affirmatively decline participation?**

Yes, a plan that provides for a cash or deferred election can stipulate that contributions will be made in the absence of an affirmative election by you declining participation. If such plan has both pre-tax elective contributions and designated Roth contributions, the plan must set forth the extent to which those default contributions are pre-tax elective contributions or designated Roth contributions. An employee who has not made an affirmative election is deemed to have irrevocably designated the contributions as designated Roth contributions.

**12. If designated Roth contributions are offered to one participant under a 403(b) Tax-Sheltered Annuity plan, must they be offered to all participants under that TSA plan?**

Proposed regulations under section 403(b) provide that the universal availability requirement of section 403(b)(12) includes the right to make designated Roth contributions. Thus, if any employee is given the opportunity to

designate section 403(b) elective deferrals as designated Roth contributions, then all employees must be given that right.

## **DESIGNATED ROTH ACCOUNTS**

### **1. What is a designated Roth account?**

A designated Roth account is a separate account under a section 401(k) plan or section 403(b) plan to which designated Roth contributions are made, and for which separate accounting of contributions, gains, and losses is maintained. This separate accounting requirement applies at the time the designated Roth contribution is contributed to the plan and must continue to apply until the designated Roth account is completely distributed.

### **2. Does a new account need to be established under my 401(k) or 403(b) plan to receive my designated Roth contributions?**

Yes, designated Roth contributions must be kept completely separate from previous and current 401(k) or 403(b) pre-tax elective contributions. A separate account must be established for each participant making designated Roth contributions.

## **DISTRIBUTIONS FROM DESIGNATED ROTH ACCOUNTS**

### **1. What is a qualified distribution from a designated Roth account?**

A qualified distribution is generally a distribution that is made after a 5-taxable-year period of participation and that either: is made on or after the date the employee attains age 59½; is made after the employee's death; or is attributable to the employee's being disabled.

In the case of distribution to an alternate payee or beneficiary, the age, death or disability of the employee is used to determine whether the distribution is qualified. The only exception is a rollover by an alternate payee or surviving spouse to a designated Roth account under a plan of his or her own employer, in which case it is such individual's age, death or disability that is used.

A qualified distribution from a designated Roth account is not includible in the employee's gross income.

### **2. What is a 5-taxable-year period of participation and how is it calculated?**

The 5-taxable-year period of participation begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the plan and ends when 5 consecutive taxable years have passed. If a direct rollover is made from a designated Roth account under another plan, the 5-taxable-year period for the employee under the recipient plan begins on the first day of the employee's taxable year for which the employee first had designated Roth contributions made to the other plan, if earlier.

Designated Roth contributions made by a reemployed veteran are treated as made in the taxable year with respect to which the contributions relate, as designated by the reemployed veteran.

Certain contributions do not start the 5-taxable year period of participation. For example, a year in which the only contributions consist of excess deferrals will not start the 5-taxable-year period of participation. Further, excess contributions that are distributed to prevent an ADP failure also do not begin the 5-taxable-year period of participation.

### **3. Are there any distributions that cannot be qualified distributions and includible in income?**

Yes, distributions of the following amounts are not treated as qualified distributions, are not eligible rollover distributions and are includible in income:

- Corrective distributions of elective deferrals contributed to a designated Roth account in excess of the section 415 limits (lesser of \$44,000 or 100% of earnings for 2006, \$45,000 in 2007);
- Corrective distributions of excess deferrals under section 402(g) (\$15,000 in 2006), (\$15,500 in 2007), \$20,000 if 50 or older (\$20,500 in 2007);
- Corrective distributions of excess contributions or excess aggregate contributions;
- Deemed distributions under section 72(p) (participant loan defaults).

**4. What happens if I take a distribution from my designated Roth account before the end of the 5-taxable-year period?**

A nonqualified distribution is included in the distributee's gross income to the extent allocable to income on the contract and excluded from gross income to the extent allocable to investment in the contract (basis). The amount of a distribution allocated to investment in the contract is determined by applying to the distribution the ratio of the investment in the contract to the designated Roth account balance. For example, if a nonqualified distribution of \$5,000 is made from an employee's designated Roth account when the account consists of \$9,400 of designated Roth contributions and \$600 of earnings, the distribution consists of \$4,700 of designated Roth contributions (that are not includible in the employee's gross income) and \$300 of earnings (that are includible in the employee's gross income).

**5. Since designated Roth contributions are made after-tax, can I withdraw from my designated Roth account at any time and without taxes?**

No, the plan's restrictions on withdrawals that apply to pre-tax elective contributions also apply to designated Roth contributions. So if your plan permits distributions from your 401(k) or 403(b) accounts on account of hardship, you may choose to receive a hardship distribution from your designated Roth account. But such a distribution will consist of a pro-rata share of earnings and basis and the earnings will be included in gross income unless you have had the designated Roth account for 5 years and are either disabled or over age 59 ½.

**ROLLOVERS OF DESIGNATED ROTH CONTRIBUTIONS**

**1. Can distributions from a designated Roth account be rolled over to a designated Roth account of another employer or into a Roth IRA?**

If the portion of a distribution from a designated Roth account that is not includible in income is to be rolled over into a designated Roth account under another plan, the rollover of the distribution must be accomplished through a direct rollover (i.e., a rollover to another designated Roth account is not available for the portion of the distribution not includible in gross income if the distribution is made directly to the employee) and can only be made to a 401(k) or 403(b) plan that has a designated Roth program.

If a distribution from a designated Roth account is made to the employee, the employee would still be able to roll over the entire amount (or any portion thereof) into a Roth IRA within 60 days of receipt. Under section 402(c)(2), if only a portion of the distribution is rolled over, the portion that is rolled over is treated as consisting first of the amount of the distribution that is includible in gross income. Alternatively, the employee is permitted to roll over the taxable portion of the distribution to a designated Roth account under either a section 401(a) or 403(b) plan within 60 days of receipt. In addition, the employee's period of participation under the distributing plan is not carried over to the recipient plan for purposes of determining whether the employee satisfies the 5-taxable-year requirement under the recipient plan.

**2. How is the 5-taxable-year period calculated in the case of a rollover of a distribution from a designated Roth account maintained under a section 401(k) or 403(b) plan to a Roth IRA?**

In the case of a rollover of a distribution from a designated Roth account maintained under a section 401(k) or 403(b) plan to a Roth IRA, the period that the rolled-over funds were in the designated Roth account does not count towards the 5-taxable-year period for determining qualified distributions from the Roth IRA. However, if an individual had established a Roth IRA in a prior year, the 5-year period for determining qualified distributions from a Roth IRA that began as a result of that earlier Roth IRA contribution applies to any distributions from the Roth IRA (including a distribution of an amount attributable to a rollover contribution from a designated Roth account).

**3. Are there any examples to help explain the rollover rules?**

Yes, the following examples from the regulations under Section 402A illustrate the rollover rules.

Employee B receives a \$14,000 eligible rollover distribution that is not a qualified distribution from B's designated Roth account, consisting of \$11,000 of investment in the contract and \$3,000 of income. Within 60 days of receipt, Employee B rolls over \$7,000 of the distribution into a Roth IRA. The \$7,000 is deemed to consist of \$3,000 of income and \$4,000 of investment in the contract. Because the only portion of the distribution that could be

includible in gross income (the income) is rolled over, none of the distribution is includible in Employee B's gross income.

Employee C receives a \$12,000 distribution, which is a qualified distribution that is attributable to the employee being disabled, from C's designated Roth account. Immediately prior to the distribution, the account consisted of \$21,850 of investment in the contract (i.e., designated Roth contributions) and \$1,150 of income. For purposes of determining recovery of investment in the contract, the distribution is deemed to consist of \$11,400 of investment in the contract [ $\$12,000 \times 21,850 / (1,150 + 21,850)$ ], and \$600 of income [ $\$12,000 \times 1,150 / (1,150 + 21,850)$ ]. Immediately after the distribution, C's designated Roth account consists of \$10,450 of investment in the contract and \$550 of income. This determination of the remaining investment in the contract will be needed if C subsequently is no longer disabled and takes a nonqualified distribution from the designated Roth account.

## **REPORTING & RECORDKEEPING REQUIREMENTS FOR DESIGNATED ROTH ACCOUNTS**

### **1. Who is responsible for keeping track of the designated Roth contributions and 5-taxable-year period?**

The plan administrator or other responsible party with respect to a plan with a designated Roth account is responsible for keeping track of the 5-taxable-year period for each employee and the amount of designated Roth contributions made on behalf of such employee. In addition, the plan administrator or other responsible party of a plan directly rolling over a distribution would be required to provide the plan administrator of the recipient plan (i.e., the plan accepting the eligible rollover distribution) with a statement indicating either the first year of the 5-taxable-year period for the employee and the portion of such distribution attributable to basis or that the distribution is a qualified distribution.

### **2. Since a qualified distribution from a designated Roth account is not subject to taxation, must the distribution be reported?**

Yes, if the distribution is not a direct rollover to a designated Roth account under another eligible plan, the plan administrator or responsible party must provide to the employee, upon request, the portion of such distribution attributable to basis or that the distribution is a qualified distribution. The statement would be required to be provided within a reasonable period following the rollover (or employee request), but in no event later than 30 days following the rollover (or employee request), and the plan administrator or other responsible party for the recipient plan would be permitted to rely on these statements.

Furthermore, a distribution from a designated Roth account must be reported on Form 1099-R, "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRA, Insurance Contracts," in accordance with the instructions thereto.

### **3. Since designated Roth contributions are already included as part of wages, tips & other compensation on the Form W-2, must the amount contributed as designated Roth contributions be identified on the Form W-2 as well?**

Yes, contributions to a designated Roth account must also be separately reported on Form W-2, "Wage and Tax Statement," in accordance with the instructions thereto.

### **4. Do employees have any recordkeeping or reporting obligations?**

An employee has no reporting obligation with respect to designated Roth contributions under a section 401(k) or 403(b) plan. However, an employee rolling over a distribution from a designated Roth account to a Roth IRA should keep track of the amount rolled over in accordance with the instructions to Form 8606, "Nondeductible IRAs."

## **MISCELLANEOUS**

### **1. Are my designated Roth contributions excluded from the 401(k) plan annual nondiscrimination testing?**

No, designated Roth contributions are treated the same as pre-tax elective contributions when performing annual nondiscrimination testing.

**2. If I am required to take a corrective distribution under my 401(k) plan due to failure of the ADP nondiscrimination testing, can I take some or all of it from my designated Roth account?**

Yes, a plan can provide that the highly compensated employee (HCE), as defined in section 414(q), with elective contributions for a year that include both pre-tax elective contributions and designated Roth contributions may elect whether excess contributions are to be attributed to pre-tax elective contributions or designated Roth contributions. There is no requirement that the plan provides this option, and a plan may provide for correction without permitting an HCE to make such an election.

A distribution of excess contributions is not includible in gross income to the extent it represents a distribution of designated Roth contributions. However, the income allocable to a corrective distribution of excess contributions that are designated Roth contributions is includible in gross income in the same manner as income allocable to a corrective distribution of excess contributions that are pre-tax elective contributions. The final Roth 401(k) regulations also provide a similar rule under the correction methods that may be used when a plan fails to satisfy the actual contribution percentage (ACP) test.