To Our Clients and Friends *June 13, 2005*

NEW ROTH CONTRIBUTION OPTION UNDER 401(k) PLANS

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Participants in 401(k) plans may save for their retirement by making elective 401(k) contributions to the plan with pre-tax compensation. These elective contributions, together with earnings on the contributions, are taxed at the time that the participant receives a distribution from the 401(k) plan.

Another option for eligible individuals to save for their retirement is to contribute to a Roth IRA, which is an individual retirement account that is not a part of a 401(k) plan. Unlike pre-tax 401(k) contributions, contributions to a Roth IRA are not deductible for tax purposes; instead, they are made from the individual's after-tax compensation. However, earnings on Roth IRA contributions accumulate tax-free, and distributions from a Roth IRA are completely tax free to the individual.

However, the amounts that can be contributed to a Roth IRA are not significant and are subject to income limitations. For 2006, the maximum amount that can be contributed to a Roth IRA is $4,000. This maximum amount is phased out and eliminated for taxpayers with adjusted gross income exceeding $110,000 (Single) and $160,000 (Joint). In addition, if an individual or the individual's spouse participates in a tax-qualified retirement plan, they may be restricted or prohibited altogether from contributing to a Roth IRA.

In view of the limited availability of Roth IRAs, Congress decided to expand the Roth IRA concept to 401(k) Plans thereby providing participants in 401(k) plans with more options. Thus, beginning in 2006, Section 402A of the Internal Revenue Code (the "Code"), permits participants in 401(k) plans to designate some or all of their elective contributions to the plan as "Roth Contributions." Roth Contributions are elective contributions to 401(k) plans that are generally treated similarly to Roth IRA contributions for Federal income tax purposes. However, Roth Contributions are not subject to the same eligibility restrictions that apply to Roth IRAs. Accordingly, Roth Contributions may be made by higher income participants in 401(k) plans and can be made irrespective of whether the participant participates in another tax-qualified plan. In addition, as discussed below, the total amount of contributions to a 401(k) plan that participants can designate as Roth contributions in 2006 is $15,000 which is the maximum 401(k) contribution for 2006 ($20,000 if the participant is over age 50 and is therefore eligible to make catch-up contributions).

Roth Contributions can be made to 401(k) plans only if the 401(k) plans are amended to accept Roth Contributions and comply with other IRS requirements.

Distributions of Roth Contributions

Because Roth Contributions are made from a participant's after-tax compensation, the amount that a participant contributes as Roth Contributions are free from tax when distributed to the participant. However, the earnings on the Roth Contributions are only excluded from the participant's Federal income tax if the participant receives a "qualified distribution." Similar to Roth IRAs, a qualified distribution has two requirements. First, the distribution must occur at least five years after the participant first makes a Roth Contribution to the 401(k) plan. (Special rules may apply if Roth Contributions are rolled over from another 401(k) plan). Second, the distribution must occur due to the participant's death, disability, or after the participant attains age 59½ (unlike Roth IRAs, a qualified distribution does not include a distribution for the first time purchase of a home). Thus, for example, if a participant terminates employment and elects to receive a distribution three years after making the first Roth Contribution to a 401(k) plan, earnings on the participant's Roth Contributions will be subject to Federal income tax. If applicable, a 10% early withdrawal penalty may also apply to the distribution.

401(k) Plan Requirements for Roth Contributions--IRS Issues Proposed Regulations

The IRS has recently issued proposed regulations setting forth the requirements that a 401(k) plan would have to satisfy in order to allow participants to make Roth Contributions to the 401(k) plan:

1. Roth Contributions Must Satisfy Elective Contribution Requirements

Roth Contributions must be nonforfeitable. Roth Contributions must also count towards the annual dollar limitation that applies to all elective deferrals. Consequently, the maximum amount of *combined* 401(k) and Roth Contributions that a participant may make to a 401(k) plan in 2006 is $15,000 ($20,000 if the participant is over age 50 and is therefore eligible to make catch-up contributions). Additionally, Roth Contributions are taken into account for nondiscrimination testing purposes and are subject to the minimum distribution requirements for participants who attain age 70½.

2. Designation of Roth Contributions

Participants must irrevocably designate the amounts that they contribute to the 401(k) plan as Roth Contributions at the time that they elect to make the contributions. Thus, if a participant elects to have a percentage of their compensation contributed to a plan as a Roth Contribution, the participant may not subsequently request that the amount that was contributed as a Roth Contribution be instead treated as a pre-tax 401(k) contribution.

3. Segregation from Pre-tax Contributions

Roth Contributions and any earnings or losses on the Roth Contributions must be accounted for separately. 401(k) plans must therefore hold the Roth Contributions in an account that is separate from any other contributions made under the plan. Also, while employer matching contributions may be made for Roth Contributions, these matching contributions may not be made on an after-tax basis; *i.e.*, both the matching contribution and related earnings are subject to federal income tax when distributed to the participant. Accordingly, because of the disparate tax treatment, employer matching contributions, even if based upon Roth Contributions, must be held and accounted for separately from Roth Contributions. Similarly, forfeitures of employer contributions, such as matching contributions or profit sharing contributions, cannot be allocated to a participant's Roth Contribution account.

Planning Ahead--Issues to be Considered by Plan Sponsors

The proposed regulations apply to plan years that begin on or after January 1, 2006. Therefore, plan sponsors should begin considering whether they want to add a Roth Contribution feature to their 401(k) plan. Issues that plan sponsors should consider include the capabilities of their 401(k) plan's recordkeeper to satisfy the separate accounting requirements that apply to Roth Contributions and the extra costs that may be incurred in order for the recordkeeper to comply with these requirements. Plan sponsors must also consider how they or their recordkeeper would track the five-year waiting period that a participant must satisfy in order to receive a qualified distribution of Roth Contributions. Plan sponsors should also consider that the provisions of the Code which permit Roth Contributions are currently scheduled to expire on December 31, 2010 and that accordingly, unless extended, 401(k) plans may be able to provide participants with the ability to make Roth Contributions only for a limited period of time. (Legislation has recently been proposed which would repeal Roth Contributions altogether). Plan sponsors who ultimately implement Roth Contributions under their 401(k) plan will have to update plan documents, forms, and participant communications to reflect the addition of the Roth Contribution feature to their plan.

The IRS has stated that they expect to finalize the regulations in time for plan sponsors to implement Roth Contributions under their plans beginning in 2006. Accordingly, while it is important that plan sponsors begin the process of determining whether they are interested in adding a Roth Contribution feature to their 401(k) plans, they should not make any final decisions or begin any implementation process, until final and complete guidance on Roth Contributions is issued by the IRS.

If you have any questions or would like further information about this Alert, please call Norman J. Misher at (212) 903-8733; Allen J. Erreich at (212) 903-8769; or Gary J. Chase at (212) 903-8737.

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