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Designated Roth IRA Contributions

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Beginning in tax year 2006, the ability to participate in a Roth IRA is extended to wage earners that previously were prohibited from contributing under the Roth IRA contribution program. Section 617(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) added this new program under §402A of the Internal Revenue Code. More recently, Treasury issued final regulations (T.D. 9237) on December 30, 2005, that addressed the contribution rules for participation in this new program.

What is the Roth IRA contribution program?

As provided in the Senate Committee Report (S. Rep. No. 107-30), members felt that some individuals may prefer to save through a Roth IRA rather than a traditional IRA and, as such, participants in 401(k) and tax-sheltered annuities should have the opportunity to make similar savings choices. Therefore, the "qualified Roth contribution program" was created for a select group of taxpayers. IRC §402A(b)(1) defines a "qualified Roth contribution program" (qualified plan) to mean "a program under which an employee may elect to make designated Roth contributions *in lieu of all or a portion of* elective deferrals the employee is otherwise eligible to make under the applicable plan" (emphasis added). This means that employer plans that offer qualified cash or deferred compensation arrangements (CODA), known as "(pre-tax) elective contributions," which aren't includible in gross income, may permit employees to designate part or all of those contributions as Roth contributions, which *would* be includible in gross income in the year of contribution but excludable in the year of a qualified withdrawal. If a company's qualified plan offers employees the option of making a designated Roth IRA contribution, they must also provide a pre-tax elective plan option as well (T.D. 9237). Thus these employees have the ability to allocate their elective contribution amount between a pre-tax and post-tax plan.

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Under this new program, a qualified plan must satisfy some special rules as provided in Reg. §1.401(k)-1(f). First, the qualified plan must establish separate accounts for each employee's contributions and earnings on such contributions. As such, the qualified plan must maintain separate recordkeeping for each account. This provision applies at the time the (designated Roth and/or pre-tax) contribution is contributed to the plan and continues to apply until the account is completely distributed.

Second, the contributions must satisfy the CODA rules for elective contributions under Reg. §1.401(k)-1(c) and (d). That is, the employee (or the plan's designated default rule, if the employee is silent; for example, if automatically enrolled by the employer) makes a one-time, irrevocable election at the time of the cash or deferral election to have the employer redirect a portion of their salary or wages (e.g., 5%) into a pension contribution. Likewise, distributions from the account must adhere to most of the rules applicable to Roth IRAs, such as those for death, disability, hardship, termination, special purposes, etc. Be aware that not all distribution rules applicable to the Roth IRA are applicable to the designated Roth IRA. For example, the required minimum distribution rules apply to the designated Roth IRA but not the regular Roth IRA; the distribution rules are discussed later in this column.

Third, the employer must treat the contribution amount as includible in the employee's gross income (§402A(a)(2)), which means the amount is treated as wages that are subject to withholdings provisions. By increasing an employee's wages, the individual's adjusted gross income (AGI) is also increasing, which can lead to a lowering of itemized deductions, increasing AMT, and increasing state income tax liabilities. All of these may or may not be attractive to an employee and may partially explain the lack of enthusiasm on the part of companies to amend their 401(k) plans to include the Roth plan option.

Fourth, designated Roth IRA contributions are treated as elective contributions for purposes of satisfying the actual deferred percentage test (Reg. §1.401(k)-1(b)(2) and (4)). This test states that a plan must not discriminate in favor of highly compensated employees and provides the mathematical ratios used to determine if a plan is discriminatory.

Fifth, employees must have an effective opportunity to make (or change) an election to make designated Roth contributions at least once during each plan year (T.D. 9237).

What are the contribution amounts?

The annual designated Roth IRA contribution is the lesser of the amount set by the requirements applicable to elective contributions under a qualified CODA (§402A(c)(2)) or the limits of the plan itself. The preamble to Treasury Decision 9237 also stipulates this restriction. Under §402(g), the maximum contribution amount for 2006 is $15,000. If the employee is at least 50 years old, the maximum contribution amount is $20,000 (§414(v)(2)(B)(i)). These amounts are scheduled to be adjusted for inflation beginning in 2007.

Unlike a Roth IRA, there is no AGI limitation placed on an employee's ability to make a designated Roth IRA contribution. Thus an employee with AGI in excess of $100,000 can still make an elective contribution to the company's 401(k) Roth IRA plan, but it should be noted that only an employee can make an elective contribution to this plan. That means matching contributions, general employer contributions, and forfeiture allocations aren't permitted (T.D. 9237).

What about rollovers?

This may be one of the more puzzling areas of the designated Roth IRA provision. To begin with, per §402A(c)(3), a direct rollover from a designated Roth IRA account may only be made to another designated Roth account under an applicable retirement plan or to a Roth IRA. This provision seems simple, straightforward, and harmless, but it isn't. In order to make a direct rollover to a designated Roth IRA plan, that plan must permit such transfers. And even if the plan generally permits such transfers, it isn't required to do so if the balance is less than $200 (Reg. §1.401(a)(31)-1). As one may remember, many qualified plans still don't permit an employee to transfer the assets from a prior employer's qualified plan into their plan for fear of the plan becoming disqualified because of, for example, violations to antidiscrimination rules. Why then would one expect this type of transfer to be viewed any differently?

Conversion rules for designated Roth IRAs differ from conventional Roth IRAs as well. A traditional IRA may be converted to a Roth IRA (§408A(d)(3)), but pre-tax elective contributions may not be converted to a designated Roth account. Further, while §512 of P.L. 109-222 allows liberal conversions in 2010 from regular IRAs to Roth IRAs (a move that may be strategically advantageous to taxpayers regardless of income and provides for a two-installment payment of extra tax due), it doesn't allow a conversion from a regular IRA to a designated Roth IRA.

What are the distribution rules?

There are significant differences between the distribution rules for a designated Roth plan and a Roth plan. For instance, the ordering rules provided under §408A(d) don't apply to designated Roth plans. Instead, §72 rules for annuities apply in determining the character of distributions from designated Roth IRAs. An employee having both a pre-tax contribution plan and a designated Roth IRA may determine, plan permitting, whether a minimum distribution is made from the pre-tax or the designated Roth account. As already mentioned, the required minimum distribution rules do apply (§402A(d)), similar to those rules that would apply under pre-tax elective contributions found in §401(a)(9).

Are there other significant provisions?

Designated Roth contributions may provide a basis for subsequent participant loans against one's individual account balance in the plan (T.D. 9237). Excess contributions made by highly compensated employees must be corrected when a plan fails to meet the antidiscrimination rules for a year. When both pre-tax elective contributions and designated Roth contributions have been made, the employee may elect which of these accounts are to be attributed with the excess, if the company's plan offers this option. Suffice it to say, one might be inclined to transfer the designated Roth IRA assets into a Roth IRA and thereby gain better flexibility in the plan. But this discussion is better left until the final regulations are issued.

Looking forward

On the surface, the ability to make contributions to a designated Roth IRA seems appealing. Wage earners—especially high-income earners—who previously couldn't make such contributions are now able to if their company sponsors a 401(k) or tax-sheltered annuities plan and elects to amend its plan to include the designated Roth IRA contribution option. That's a lot of ifs, especially when you include the fact that the Economic Growth and Tax Relief Reconciliation Act of 2001 will sunset after 2010 unless the sunset is repealed or this provision is extended or made permanent. But the good news is that the designated Roth plan is a revenue raiser and, as such, will be seen in a positive light by our legislature. ■

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