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Proposed Regulations for Roth 401(k) Distributions

With the release of proposed regulations for Roth 401(k) distributions, taxation, and reporting, practitioners are finding surprises, clarifications, and complications caused by the interaction of a number of rules.

This article covers the highlights of the proposed distribution regs. A discussion of the complex rollover issues will be presented in a subsequent issue, as will the final regulations — as soon as they are issued.

“Qualified distributions” of Roth 401(k) earnings and contributions are not subject to federal income tax — they are tax free. A qualified distribution is one that is made after a five-taxable-year exclusion period has passed and the participant is 59½ years of age, disabled, or deceased.

The five-year exclusion period begins January 1 of the year the first Roth 401(k) deferral contribution is made to the plan. For example, if Mary makes her first Roth 401(k) contribution on October 31, 2006, her five-year exclusion period begins on January 1, 2006, and runs for five consecutive years. In this case, Mary will satisfy the five-year requirement of the qualified distribution rule as of January 1, 2011. To complete the qualified distribution requirements, Mary will also need to be 59½ years of age or older (or disabled or deceased).

The five-year rule applies separately to each retirement plan an individual participates in over his or her career.

Here’s an illustration: Joe works for company ABC and makes Roth 401(k) contributions from 2006 to 2018.

Joe has certainly satisfied the five-year exclusion rule. Once he meets one of the other requirements, Joe will be eligible for qualified distributions.

In 2019, at age 45, Joe leaves ABC and starts work at company XYZ. The five-year rule starts anew for the Roth contributions Joe makes to XYZ’s plan, provided he does not roll over his ABC plan contributions. (The rollover rules are complex and will be discussed in detail in a future article.)

A nonqualified distribution is defined as any distribution that does not meet the definition of a qualified distribution. Thus, if the five-year rule is not met, even if the individual meets the age requirement, the distribution is not qualified, and, therefore, is not tax free. If the five-year rule is met, but the individual has not yet reached age 59½



and is not disabled or deceased, then, again, the distribution is not qualified.

The tax treatment of nonqualified Roth distributions is based on a pro rata distribution of earnings and Roth contributions. (The pro rata method is also used for determining the tax treatment of distributions of after-tax contributions deposited in a qualified plan after 1986

(Continued on page 2)

CONTENTS

Proposed Regulations for Roth 401(k) Distributions

Recap: Post-severance Compensation

A New Definition of “Dependent”

2999 Douglas Boulevard
Suite 155
Roseville, CA 95661
(800) 952-8800

6400 Canoga Avenue
Suite 250
Woodland Hills, CA 91367
(800) 736-7090

404 Camino del Rio South
Suite 608
San Diego, CA 92108
(800) 572-4122

www.Polycomp.net

Proposed Regulations for Roth 401(k) Distributions *(Continued from page 1)*



and after-tax amounts in a traditional IRA.) The earnings portion of a non-qualified distribution is taxed, and, if the individual is younger than age 59½, is also subject to a 10% penalty. If the

individual is over 59½, the 10% penalty does not apply.

Here's an example of a pro rata distribution: Sam has \$50,000 in traditional IRAs, of which \$10,000 is nondeductible (after-tax) money. He takes a distribution of \$5,000. The nontaxable amount is calculated by dividing the nondeductible amount by the total amount and multiplying it times the distribution: $\$10,000 \div \$50,000 = .2 \times \$5,000 = \$1,000$. Thus, \$1,000 of the distribution represents after-tax dollars, and \$4,000 is taxable.

The proposed regulations permit the use of Roth amounts for loans.

If the loan becomes a deemed distribution, however, the portion representing Roth earnings is taxable. Plans may

want to adopt a policy that allows vested Roth account balances to be used in determining loan amounts, but restricts funding to non-Roth sources only.

Roth accounts may be made available for hardship distributions. However, the proposed regulations state that if Roth amounts are used for hardship distributions, they are taxed on a pro rata basis. And, if the individual is under age 59½ and is not disabled, the earnings portion is subject to the 10% penalty. Should additional hardship distributions occur, the amount already distributed — including the taxed earnings — is subtracted from the total amount of Roth deferrals available. ❖

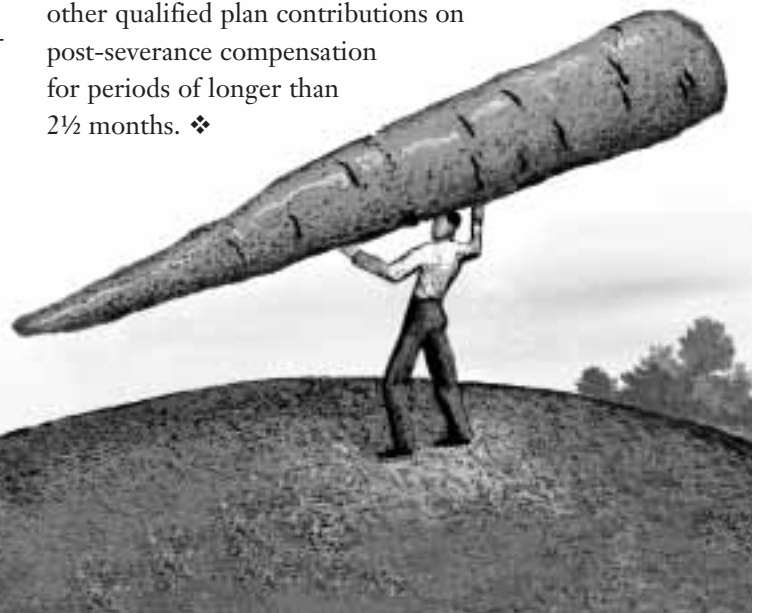
Recap: Post-severance Compensation

Until recently, there was no IRS guidance on post-severance compensation. When an employee received a severance package, the employer had, arguably, wide latitude in allowing post-severance compensation for qualified plan purposes. It was not uncommon for post-severance compensation to count toward deferrals, matches, and other employer contributions for periods of up to six months or longer.

Although we covered this topic at length in a prior article, there are still many questions to address.

Basically, post-severance compensation is included for qualified plan purposes (provided the plan does not exclude post-severance compensation from the definition of compensation) if it's paid within 2½ months after separation from service. This is only for payments — regular compensation, overtime pay, commissions, and bonuses — that would have been paid had the participant continued in employment. Severance payments for bona fide sick, vacation, and other leave may be included *only if* the leave was accrued before termination and could have been used had employment continued. This is effective for plan years beginning on or after January 1, 2005.

Example: An employee terminated on June 10, 2005, with three weeks of unused vacation time. The employer pays the participant for the three weeks on June 24. The participant may make elective deferrals on this compensation amount and is entitled to have that payment included in plan compensation for employer contribution purposes because it is paid within 2½ months of severance. If the employee is given six months' pay on a payroll basis, only the first 2½ months of post-severance pay would be eligible for deferrals and employer contributions. Employers no longer have the discretion to permit elective deferrals or other qualified plan contributions on post-severance compensation for periods of longer than 2½ months. ❖



A New Definition of “Dependent”

The Working Families Tax Relief Act of 2004 (WFTRA) provided a uniform definition of “dependent” under IRC Section 152. The definition applied to all employee benefit plans as of the 2005 calendar year. The Gulf Opportunity Zone Act of 2005 (GOZA, which was enacted primarily to provide additional relief to hurricane victims) included much-needed technical corrections to the definition of dependent, thereby clarifying its application to certain employee benefit plans.

The new definition, which is retroactive to January 1, 2005, could have an impact on the operation of retirement plans in three areas.

Hardship withdrawals. Three of the six safe harbor reasons for hardship withdrawals include the word dependent. (The other three safe harbor reasons do not.)

1. The first reason is to pay medical expenses for dependents (and others).
2. The second reason is to pay post-secondary education expenses. This provision permits participants to make a hardship withdrawal to pay tuition and related expenses (including but not limited to expenses associated with room and board) for the next twelve months of post-secondary education for the participant, his or her spouse, or other dependents.
3. The third reason is a new safe harbor included in the final 401(k) regulations (effective for plan years beginning on or after December 31, 2005). It allows hardship distributions for burial or funeral expenses for a participant’s deceased parents, spouse, children, or dependents.

(Prototype plan documents that have hardship provisions already offer the first two safe harbor reasons and will be adding the third during the 2006 plan year.)

QDROs. The term dependent also appears in retirement plan documents in reference to Qualified Domestic Relations Orders (QDROs). QDROs may name a child or dependent as an alternate payee.



Deemed IRA. If a plan contains a deemed IRA provision, eligibility for the saver’s tax credit requires that an individual not be claimed as another person’s dependent.

What are the changes to the definition? Plan administrators are responsible for defining who qualifies as a dependent for plan purposes, including the hardship withdrawal and QDRO issues noted earlier. Thus, it is important for administrators to fully understand any changes in the definition. For qualified plan purposes, the technical changes made to the IRC definition of dependent by GOZA are:

- Dependent status is no longer affected by an individual’s annual gross income. The income limit of \$3,200 set by WFTRA for 2005 no longer applies. And there is no dollar limit for 2006 or future years.
- As long as the definition is otherwise met, an individual may be a dependent even if he or she is married and filing a joint return.
- As long as the definition is otherwise met, an individual may be a dependent even if he or she has his or her own dependents.
- A divorced or legally separated custodial parent may make a written declaration to waive his or her right to claim a child as a dependent for purposes of the child tax credit and the dependency exemption only, but not with respect to other child-related benefits. Pursuant to such a waiver, the non-custodial parent will still be able to claim the child as a dependent for qualified plan purposes. ❖

recent developments

■ **FDIC Insurance Coverage Increases.** The Deficit Reduction Act of 2005 increases the FDIC (Federal Deposit Insurance Corporation) coverage for IRAs and other retirement accounts held in FDIC-insured banks or thrifts from \$100,000 to \$250,000. This increase generally includes FDIC-insured retirement accounts that are eligible for “pass-through” coverage for each participant. For example, if an FDIC-insured retirement account of \$600,000 represents the accounts of five participants, each with \$120,000, then each participant will be insured by the FDIC up to the legal maximum. The current coverage for this account is \$500,000 — \$100,000 each times five participants. Under the new law, the coverage will

be \$250,000 per participant. The maximum insurance coverage for all other consumer accounts remains at \$100,000. However, the limit will be reviewed every five years and adjusted for cost-of-living increases as necessary beginning in 2011.

■ **PBGC Premiums Increase.** The Deficit Reduction Act of 2005 also increases the Pension Benefit Guaranty Corporation (PBGC) premiums for both single and multi-employer defined benefit (DB) plans. As of the 2006 plan year (and effective retroactively to January 1), the premium for single employers increases from \$19 to \$30 per participant, and the multi-employer premiums increase from \$2.60 to \$8.00 per

participant. PBGC premiums will be subject to cost of living adjustments (COLAs) based on the wage-based index used for Social Security. Employers who filed estimated premiums based on the old rate will need to submit an amended filing. For premium forms and instructions, go to www.pbgc.gov/.

After December 31, 2005, if an underfunded DB plan is terminated under distress or involuntary termination proceedings, an additional premium surcharge of \$1,250 per participant will be imposed annually for three years after the employer emerges from bankruptcy. This fee applies only to employers filing for bankruptcy on or after October 18, 2005. ❖

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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2999 Douglas Boulevard
Suite 155
Roseville, CA 95661

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