

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9237]

RIN 1545-BE05

Designated Roth contributions to cash or deferred arrangements under section 401(k)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains amendments to the regulations under section 401(k) and (m) of the Internal Revenue Code. These regulations provide guidance concerning the requirements for designated Roth contributions under qualified cash or deferred arrangements described in section 401(k). These regulations affect section 401(k) plans that provide for designated Roth contributions and participants eligible to make elective contributions under these plans.

Dates: Effective Date: These regulations are effective January 3, 2006.

Applicability Date: These regulations apply to plan years beginning on or after January 1, 2006.

FOR FURTHER INFORMATION CONTACT: Cathy A. Vohs, 202-622-6090 or R. Lisa Mojiri-Azad, 202-622-6060 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1930.

The collection of information in these regulations is in 26 CFR §1.401(k)-1(f)(1)&(2). This information is required to comply with the separate accounting and recordkeeping requirements of section 402A.

The estimated annual burden per respondent under control number 1545-1930 is 1 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:CAR:MP:T:T:SP Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## **Background**

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under section 401(k) and (m) of the Internal Revenue Code of 1986 (Code). The amendments provide guidance on designated Roth contributions under section 402A of the Code, added by section 617(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16, 115 Stat. 38) (EGTRRA).

Section 401(k) provides that a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan will not fail to qualify under section 401(a) merely because it contains a qualified cash or deferred arrangement. Contributions made at the election of an employee under a qualified cash or deferred arrangement are known as elective contributions. Generally, such elective contributions are not includable in gross income at the time contributed and are sometimes referred to as pre-tax elective contributions.

Under section 402A, effective for tax years beginning on or after January 1, 2006, a plan may permit an employee who makes elective contributions under a qualified cash or deferred arrangement to designate some or all of those contributions as designated Roth contributions. Designated Roth contributions are elective contributions under a qualified cash or deferred arrangement that, unlike pre-tax elective contributions, are currently includable in gross income. However, a qualified distribution of designated Roth contributions is excludable from gross income.

Although designated Roth contributions under a qualified cash or deferred arrangement bear some similarity to contributions to a Roth IRA described in section 408A (e.g., contributions to either type of account are after-tax contributions and

qualified distributions from either type of account are excludable from gross income), there are many differences between these types of arrangements. For example, under section 408A(c)(3), an individual is ineligible to make Roth IRA contributions if his or her modified adjusted gross income exceeds certain limits, but section 402A does not impose any comparable income limits on an individual's eligibility to make designated Roth contributions under a qualified cash or deferred arrangement. In addition, under section 408A(d)(3), a traditional IRA may be converted to a Roth IRA, but section 402A does not provide for a conversion of a pre-tax elective contribution account under a qualified cash or deferred arrangement to a designated Roth account. Also, under section 408A(d)(4), specific ordering rules apply to distributions from Roth IRAs. Section 402A, however, does not provide a specific ordering rule for distributions from designated Roth accounts, so section 72 applies to determine the character of distributions from such accounts.

On December 29, 2004, final regulations under section 401(k) were issued (69 FR 78144). Those regulations generally apply to plan years beginning on or after January 1, 2006, although they also may be applied to plan years ending after December 29, 2004. Under those final regulations, §1.401(k)-1(f) was reserved for special rules for designated Roth contributions. On March 2, 2005, proposed regulations to fill in that reserved paragraph and provide additional rules applicable to designated Roth contributions were issued (70 FR 10062). Written public comments were received on the proposed regulations and public reaction to the proposed regulations generally was favorable. After consideration of the comments, these final

regulations adopt the provisions of the proposed regulations with certain modifications, the most significant of which are highlighted below.

## **Explanation of Provisions**

### Rules Relating to Designated Roth Contributions

These final regulations retain the special rules which were included in the proposed regulations relating to designated Roth contributions under a section 401(k) plan. Thus, these final regulations amend §1.401(k)-1(f) to provide a definition of designated Roth contributions and special rules with respect to such contributions. Under these final regulations, designated Roth contributions are defined as elective contributions under a qualified cash or deferred arrangement that are: (1) designated irrevocably by the employee at the time of the cash or deferred election as designated Roth contributions that are being made in lieu of all or a portion of the pre-tax elective contributions the employee is otherwise eligible to make under the plan; (2) treated by the employer as includable in the employee's gross income at the time the employee would have received the contribution amounts in cash if the employee had not made the cash or deferred election (e.g., by treating the contributions as wages subject to applicable withholding requirements); and (3) maintained by the plan in a separate account. The regulations also provide that elective contributions may only be treated as designated Roth contributions to the extent permitted under the plan.

Some commentators requested that an employer sponsoring a qualified cash or deferred arrangement be permitted to offer only designated Roth contributions. However, under section 402A(b)(1), designated Roth contributions are made in lieu of

all or a portion of elective contributions that the employee is otherwise eligible to make under the cash or deferred arrangement. If a cash or deferred arrangement offered only designated Roth contributions, an employee participating in the arrangement would not be electing to make such contributions in lieu of elective contributions he or she was otherwise eligible to make under the plan. Thus, these final regulations clarify that, in order to provide for designated Roth contributions, a qualified cash or deferred arrangement must also offer pre-tax elective contributions.

#### Separate Accounting Requirement

These final regulations also retain the rule that, under the separate accounting requirement, contributions and withdrawals of designated Roth contributions must be credited and debited to a designated Roth account maintained for the employee and the plan must maintain a record of the employee's investment in the contract (i.e., designated Roth contributions that have not been distributed) with respect to the employee's designated Roth account. In addition, gains, losses, and other credits or charges must be separately allocated on a reasonable and consistent basis to the designated Roth account and other accounts under the plan. The proposed regulations provided that forfeitures may not be allocated to the designated Roth account. The final regulations retain this rule and, in response to comments, clarify that no contributions other than designated Roth contributions and rollover contributions described in section 402A(c)(3)(B) are permitted to be allocated to a designated Roth account. For example, matching contributions are not permitted to be allocated to a designated Roth account. The final regulations also retain the rule that the 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.

#### Other Rules

These final regulations retain the requirement that a designated Roth contribution must satisfy the requirements applicable to any other elective contributions made under a qualified cash or deferred arrangement. Thus, designated Roth contributions are subject to the nonforfeitality and distribution restrictions applicable to elective contributions and are taken into account under the actual deferral percentage test (ADP test) of section 401(k)(3) in the same manner as pre-tax elective contributions. Similarly, designated Roth contributions may be treated as catch-up contributions and serve as the basis for a participant loan.

A number of commentators discussed the application of section 401(a)(9) to plans to which designated Roth contributions are made. These commentators pointed out that under section 408A, Roth IRAs are not subject to the rules of section 401(a)(9)(A) (i.e., Roth IRAs are not subject to the rules of section 401(a)(9) while the Roth IRA owner is alive). Although Roth IRAs are not subject to section 401(a)(9) while the IRA owner is alive, section 402A does not provide comparable rules regarding the application of section 401(a)(9) to designated Roth accounts under a cash or deferred arrangement. Thus, such designated Roth accounts are subject to the rules of section 401(a)(9) (A) and (B) in the same manner as pre-tax elective contributions.

In response to comments asking for clarification, the final regulations provide rules regarding elections to make designated Roth contributions. These rules

specifically provide that the rules in §1.401(k)-1(e)(2)(ii) regarding frequency of elections to make pre-tax elective contributions also apply to elections to make designated Roth contributions. The rules also specifically address automatic enrollment and permit a plan to utilize automatic enrollment in conjunction with designated Roth contributions. Under the final regulations, a plan that provides for a cash or deferred election under which contributions are made in the absence of an affirmative election and that has both pre-tax elective contributions and designated Roth contributions must set forth the extent to which those default contributions are pre-tax elective contributions or designated Roth contributions. If the default contributions are designated Roth contributions, then an employee who has not made an affirmative election is deemed to have irrevocably designated the contributions (in accordance with section 402A(c)(1)(B)) as designated Roth contributions.

A number of commentators addressed direct rollovers of amounts from a designated Roth account. In response to these comments, the regulations clarify that a direct rollover from a designated Roth account under a qualified cash or deferred arrangement may only be made to another designated Roth account under an applicable retirement plan described in section 402A(e)(1) or to a Roth IRA described in section 408A, and only to the extent the direct rollover is permitted under the rules of section 402(c). In addition, a plan is permitted to treat the balance of the participant's designated Roth account and the participant's other accounts under the plan as accounts held under two separate plans (within the meaning of section 414(l)) for purposes of applying the special rule in A-11 of §1.401(a)(31)-1

(under which a plan will satisfy section 401(a)(31) even though the plan administrator does not permit any distributee to elect a direct rollover with respect to eligible rollover distributions during a year that are reasonably expected to total less than \$200). Thus, if a participant's balance in the designated Roth account is less than \$200, then the plan is not required to offer a direct rollover election with respect to that account or to apply the automatic rollover provisions of section 401(a)(31)(B) with respect to that account.

Section 1.401(k)-2 contains correction methods that may be used when a plan fails to satisfy the ADP test for a year. These final regulations retain the rule in the proposed regulations relating to these correction methods that permits a 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 to elect whether excess contributions are to be attributed to pre-tax elective contributions or designated Roth contributions. There is no requirement that the plan provide this option, and a plan may provide for one of the correction methods described in the final regulations without permitting an HCE to make such an election.

These final regulations also retain the rule that a distribution of excess contributions is not includable 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 includable in gross income in the same manner as income allocable to a corrective distribution of excess contributions that are pre-tax elective contributions. The 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 in §1.401(m)-2.

#### Additional Plan Terms

In addition to the rules relating to section 401(k) and (m) discussed above, there are other aspects of designated Roth contributions that would be reflected in plan terms and are not addressed in these regulations. For example, while a plan is permitted to allow an employee to elect the character of a distribution (i.e., whether the distribution will be made from the designated Roth account or other accounts), the extent to which a plan so permits must be set forth in the terms of the plan.

#### Certain Issues Addressed in Proposed Regulations

These final regulations do not provide guidance with respect to the taxation of distributions of designated Roth contributions. For example, the regulations do not provide guidance with respect to the recovery of an employee's investment in the contract associated with his or her designated Roth contributions. Proposed regulations under section 402A, to be issued in the near future, address these taxation issues.

#### **Effective Date**

Section 402A is effective for an employee's taxable years beginning after December 31, 2005. These regulations have the same effective date as the regulations under section 401(k) that they are amending. Thus, these final regulations are generally applicable to plan years beginning on or after January 1, 2006. If a plan is applying the section 401(k) regulations as of an earlier effective date (as provided under those regulations), to the extent that section 402A is effective, that same early effective date applies to these regulations. For a plan that has an effective date for the section

401(k) regulations that is after the effective date of section 402A (either an employer that does not have a calendar year plan or a plan established pursuant to a collective bargaining agreement that has a delayed effective date for the section 401(k) regulations), the employer may rely on these regulations prior to the effective date of the final section 401(k) regulations for the plan, even if the plan does not otherwise implement the section 401(k) regulations earlier than required.

These regulations do not provide rules for the application of the EGTRRA sunset provision (section 901 of EGTRRA), under which the provisions of EGTRRA do not apply to taxable, plan, or limitation years beginning after December 31, 2010. Unless the EGTRRA sunset provision is repealed before it becomes effective, additional guidance will be needed to clarify its application.

### **Special Analyses**

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that 5 U.S.C. 553(b) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that most small entities that maintain a section 401(k) plan use a third party provider to administer the plan. Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were

submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

The principal authors of these regulations are R. Lisa Mojiri-Azad and Cathy A. Vohs of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in the development of these regulations.

### **List of Subjects**

#### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### 26 CFR Part 602

Reporting and recordkeeping requirements.

### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

#### **PART 1 -- INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.401(k)-0 is amended as follows:

1. The entry for §1.401(k)-1(f) is revised and entries for §1.401(k)-1(f)(1), (2), (3), (4) and (5) are added.
2. An entry for §1.401(k)-2(b)(2)(vi)(C) is added.

The additions read as follows:

§1.401(k)-0 Table of contents.

\* \* \* \* \*

§1.401(k)-1 Certain cash or deferred arrangements.

\* \* \* \* \*

- (f) Special rules for designated Roth contributions.
  - (1) In general.
  - (2) Separate accounting required.
  - (3) Designated Roth contributions must satisfy rules applicable to elective contributions.
    - (i) In general.
    - (ii) Special rules for direct rollovers.
  - (4) Rules regarding designated Roth contribution elections.
    - (i) Frequency of elections.
    - (ii) Default elections.
  - (5) Effective date.
    - (i) In general.
    - (ii) Sunset provisions.

\* \* \* \* \*

§1.401(k)-2 ADP test.

\* \* \* \* \*

- (b) \* \* \*
- (2) \* \* \*
- (vi) \* \* \*
- (C) Corrective distributions attributable to designated Roth contributions.

\* \* \* \* \*

Par. 3. Section 1.401(k)-1(f) is revised as follows:

§1.401(k)-1 Certain cash or deferred arrangements.

\* \* \* \* \*

- (f) Special rules for designated Roth contributions-(1) In general. The term

designated Roth contribution means an elective contribution under a qualified cash or deferred arrangement that, to the extent permitted under the plan, is--

- (i) Designated irrevocably by the employee at the time of the cash or deferred election as a designated Roth contribution that is being made in lieu of all or a portion of the pre-tax elective contributions the employee is otherwise eligible to make under the plan;
- (ii) Treated by the employer as includable 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 cash or deferred election (e.g., by treating the contributions as wages subject to applicable withholding requirements); and
- (iii) Maintained by the plan in a separate account (in accordance with paragraph (f)(2) of this section).

(2) Separate accounting required. Under the separate accounting requirement of this paragraph (f)(2), contributions and withdrawals of designated Roth contributions must be credited and debited to a designated Roth account maintained for the employee and the plan must maintain a record of the employee's investment in the contract (i.e., designated Roth contributions that have not been distributed) with respect to the employee's designated Roth account. In addition, gains, losses, and other credits or charges must be separately allocated on a reasonable and consistent basis to the designated Roth account and other accounts under the plan. However, forfeitures may not be allocated to the designated Roth account and no contributions other than designated Roth contributions and rollover contributions described in section

402A(c)(3)(B) may be allocated to such account. The 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.

(3) Designated Roth contributions must satisfy rules applicable to elective contributions--(i) In general. A designated Roth contribution must satisfy the requirements applicable to elective contributions made under a qualified cash or deferred arrangement. Thus, for example, a designated Roth contribution must satisfy the requirements of paragraphs (c) and (d) of this section and is treated as an employer contribution for purposes of sections 401(a), 401(k), 402, 404, 409, 411, 412, 415, 416 and 417. In addition, the designated Roth contributions are treated as elective contributions for purposes of the ADP test. Similarly, the designated Roth account under the plan is subject to the rules of section 401(a)(9)(A) and (B) in the same manner as an account that contains pre-tax elective contributions.

(ii) Special rules for direct rollovers. A direct rollover from a designated Roth account under a qualified cash or deferred arrangement may only be made to another designated Roth account under an applicable retirement plan described in section 402A(e)(1) or to a Roth IRA described in section 408A, and only to the extent the rollover is permitted under the rules of section 402(c). Moreover, a plan is permitted to treat the balance of the participant's designated Roth account and the participant's other accounts under the plan as accounts held under two separate plans (within the meaning of section 414(l)) for purposes of applying the special rule in A-11 of §1.401(a)(31)-1 (under which a plan will satisfy section 401(a)(31) even though the plan administrator

does not permit any distributee to elect a direct rollover with respect to eligible rollover distributions during a year that are reasonably expected to total less than \$200).

(4) Rules regarding designated Roth contribution elections--(i) Frequency of elections. The rules under paragraph (e)(2)(ii) of this section regarding frequency of elections apply in the same manner to both pre-tax elective contributions and designated Roth contributions. 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.

(ii) Default elections--(A) In the case of a plan that provides for both pre-tax elective contributions and designated Roth contributions and in which, under paragraph (a)(3)(ii) of this section, the default in the absence of an affirmative election is to make a contribution under the cash or deferred arrangement, the plan terms must provide the extent to which the default contributions are pre-tax elective contributions and the extent to which the default contributions are designated Roth contributions.

(B) If the default contributions under the plan are designated Roth contributions, then an employee who has not made an affirmative election is deemed to have irrevocably designated the contributions (in accordance with section 402A(c)(1)(B)) as designated Roth contributions.

(5) Effective date--(i) In general. Section 402A is effective for taxable years beginning after December 31, 2005.

(ii) Sunset provisions. The rules set forth in this paragraph (f) do not address the application of section 901 of the Economic Growth and Tax Relief Reconciliation Act of

2001 (Public Law 107-16; 115 Stat. 38) (under which the amendments made by that Act do not apply to taxable, plan, or limitation years beginning after December 31, 2010).

\* \* \* \* \*

Par. 4. Section 1.401(k)-2 is amended as follows:

1. A new sentence is added after the second sentence in paragraph (b)(1)(ii).
2. The last sentence in paragraph (b)(2)(vi)(B) is amended by adding the phrase ", except to the extent provided in paragraph (b)(2)(vi)(C) of this section."
3. Paragraph (b)(2)(vi)(C) is added.

The additions read as follows:

§1.401(k)-2 ADP test.

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(ii) \* \* \* Similarly, a plan may permit an HCE with elective contributions for a year that includes both pre-tax elective contributions and designated Roth contributions to elect whether the excess contributions are to be attributed to pre-tax elective contributions or designated Roth contributions. \* \* \*

\* \* \* \* \*

(2) \* \* \*

(vi) \* \* \*

(C) Corrective distributions attributable to designated Roth contributions.

Notwithstanding paragraphs (b)(2)(vi)(A) and (B) of this section, a distribution of excess contributions is not includable 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 included in gross income in accordance with paragraph (b)(2)(vi)(A) or (B) of this section (i.e., in the same manner as income allocable to a corrective distribution of excess contributions that are pre-tax elective contributions).

\* \* \* \* \*

Par. 5. Section 1.401(k)-6 is amended as follows:

1. The definitions of "Designated Roth account" and "Designated Roth contributions" are added after the definition of Current year testing method.
2. A new definition of "Pre-tax elective contributions" is added after the definition of Pre-ERISA money purchase pension plan.

The additions read as follows:

§1.401(k)-6 Definitions.

\* \* \* \* \*

Designated Roth account. Designated Roth account means a separate account maintained by a plan to which only designated Roth contributions (including income, expenses, gains and losses attributable thereto) are made.

Designated Roth contributions. Designated Roth contributions means designated Roth contributions as defined in §1.401(k)-1(f)(1).

\* \* \* \* \*

Pre-tax elective contributions. Pre-tax elective contributions means elective contributions under a qualified cash or deferred arrangement that are not designated Roth contributions.

\* \* \* \* \*

Par. 6. Section 1.401(m)-0 is amended by adding an entry for §1.401(m)-2(b)(2)(vi)(C) to read as follows:

§1.401(m)-0 Table of contents.

\* \* \* \* \*

§1.401(m)-2 ACP test.

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(vi) \* \* \*

(C) Corrective distributions attributable to designated Roth contributions.

\* \* \* \* \*

Par. 7. Section 1.401(m)-2 is amended as follows:

1. The last sentence in paragraph (b)(2)(vi)(B) is amended by adding the phrase ", or as provided in paragraph (b)(2)(vi)(C) of this section."
2. Paragraph (b)(2)(vi)(C) is added.

The additions read as follows:

§1.401(m)-2 ACP test.

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(vi) \* \* \*

(C) Corrective distributions attributable to designated Roth contributions.

Notwithstanding paragraphs (b)(2)(vi)(A) and (B) of this section, a distribution of excess aggregate contributions is not includable in gross income to the extent it represents a distribution of designated Roth contributions. However, the income allocable to a corrective distribution of excess aggregate contributions that are designated Roth contributions is taxed in accordance with paragraph (b)(2)(vi)(A) or (B) of this section (i.e., in the same manner as income allocable to a corrective distribution of excess aggregate contributions that are not designated Roth contributions).

\* \* \* \* \*

Par. 8. Section 1.401(m)-5 is amended by adding a new definition of "Designated Roth contributions" after the definition of Current year testing method to read as follows:

§1.401(m)-5 Definitions.

\* \* \* \* \*

Designated Roth contributions. Designated Roth contributions means designated Roth contributions as defined in §1.401(k)-1(f)(1).

\* \* \* \* \*

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 10. In §602.101, paragraph (b) is amended by adding an entry for "1.401(k)-1" in numerical order to the table to read, in part, as follows:

§602.101 OMB Control numbers.

\* \* \* \* \*

(b) \* \* \*

<u>CFR part or section where identified and described</u>	<u>Current OMB control No.</u>
1.401(k)-1 .....	1545-1930

Mark E. Matthews,  
Deputy Commissioner for Services and Enforcement.

Approved: December 13, 2005.

Eric Solomon,  
Acting Deputy Assistant Secretary for Tax Policy.