



Second Quarter 2005

Retirement PLAN WATCH

LINKS and LINES

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What You Should Know About Roth §403(b)s

On March 2, 2005, the IRS issued proposed regulations on Roth §401(k) contributions. Similar rules would also apply to Roth §403(b) contributions which will be possible effective January 1, 2006. Below is a summary of the key points of these proposed regulations.

- The custodian or trustee of the §403(b) account is required to maintain separate accounting of contributions and distributions of the Designated Roth Contributions and the earnings thereon. (Forfeitures under an employer-contributory plan may not be allocated to a Roth contribution account.)
- Designated Roth Contributions must be 100% vested and nonforfeitable in the same manner as pre-tax elective deferrals.
- For employer-contributory plans, adding Designated Roth Contributions is optional, not mandatory. The IRS will probably issue an IRS Model Amendment after the final regs are issued later this year for employers who wish to add this feature to their plans. For that matter, offering Designated Roth Contributions on salary-deferral-only plans is up to each vendor.
- The distributable events for Roth contributions are the same that apply to pre-tax

elective deferrals. Therefore, Roth contributions may be distributed upon attainment of age 59½, severance from employment, death, disability or under a financial hardship provision.

- The Designated Roth Contributions are elective deferral contributions under §402(g). Therefore, all of a participant's deferrals—pre-tax and Roth—are combined for the

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§402(g) elective deferral limit each year. For example, in 2006, all elective deferrals are limited to \$15,000 (plus \$5,000 for the over-age-50 catch-up). If an employee age 45 deferred \$10,000 to his pre-tax §403(b) and \$7,000 to his Roth §403(b) in 2006, s/he would have a \$2,000 excess contribution. The regs allow the employee to choose from which account to remove the excess.

- Since the Designated Roth Contributions are treated as elective deferrals, the required minimum distribution rules at age 70½ and death will apply.
- Designation of a Roth contribution is an irrevocable election. A participant may choose to defer from his/her paycheck under the pre-tax rules or the Roth rules, but once the Roth contribution is made it may not be recharacterized as a regular pre-tax elective deferral.
- Designated Roth Contributions may be rolled over to another plan (i.e., §403(b) or §401(k)) that allows for Designated Roth Contributions or to a Roth IRA.
- *Distributions from Designated Roth Contributions plus earnings will be tax-free if the distribution is made:
 - At least 5 years after the first designated Roth contribution was made; AND
 - On account of attainment of age 59½, death or disability.



Notes:

The first-time homebuyer exception under Roth IRAs is not available under a §403(b) or §401(k).

There is no AGI limit for eligibility to qualify for contributions, unlike Roth IRAs – therefore, everyone is eligible.

The proposed regs do not provide any guidance with respect to the taxation of distributions of Roth contributions and the earnings thereon. The IRS invited comments on the issues involved, i.e., recovery of basis, premature penalties, etc.

There are no provisions in the proposed regs for conversions of pre-tax monies to Roth §403(b)s. Of course, once an individual is eligible for distributions, s/he may roll pre-tax §403(b) assets to a traditional IRA and convert to a Roth IRA if s/he meets the AGI eligibility requirement of under \$100,000. This limit applies whether the taxpayer is single or married filing jointly. A taxpayer who is married filing separately is not eligible to do any conversions.

A school district, if offering the choice of deferrals to its employees, must monitor for the §402(g) elective deferral limit on an employee's combined contributions to pre-tax and Roth accounts. The payroll system must be updated to reflect this new hybrid—FICA taxes, Medicare taxes, plus federal and state income tax withholding apply. We must wait to see if reporting on Form W-2 is changed in any way.

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Rolling Roth contribution accounts to a Roth IRA after terminating employment will remove the requirement to take minimum distributions at age 70½.

Qualified Domestic Relations Orders (QDROs)

Retirement plan assets of both spouses are considered in a divorce settlement, whether held in a §403(b) account, §457 account, §401(k) account, money purchase plan, profit sharing plan, defined benefit (pension) plan or an individual retirement account (IRA).



If, as part of a negotiated settlement, assets in a §403(b) or §457 are awarded to a participant's ex-spouse, lawyers for the participant and/or the ex-spouse must file a Qualified Domestic Relations Order (QDRO) with the court. A certified copy of the QDRO must be forwarded to the plan administrator for execution of the order. IRA assets are transferred pursuant to a Transfer Incident to Divorce and a separate court order is not necessary.

The QDRO must be clear in its directions to the plan administrator regarding the type of distribution to be made to the ex-spouse (defined in the QDRO as the alternate payee). Three options normally exist:

1. the transfer of the alternate payee's interest to a separate account from which the alternate payee may not take any distribution until the participant (former spouse) (a) reaches age 59½, (b) dies or (c) separates from service;
2. the direct rollover of the alternate payee's interest to an IRA or other eligible retirement plan; and
3. a lump sum distribution made directly to the alternate payee.

If the QDRO specifies transferring the alternate payee's interest to an IRA or eligible retirement plan in the alternate payee's name, the restrictions noted for a separate account would not apply. The alternate payee could rollover the IRA to another §403(b) account (if the alternate payee is eligible to participate in a §403(b) account) or take distributions from the IRA when desired (tax penalties may apply if premature distributions are taken, i.e., prior to age 59½). If the alternate payee rolls the award to an employer's retirement plan, distributions would be restricted according to the type of plan. If

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the alternate payee takes a lump sum distribution, the IRS requires that 20% be withheld for federal income taxes; distributions paid directly to an alternate payee are exempt from the 10% premature penalty.

Domestic relations orders must contain certain information to be deemed a QDRO pursuant to IRC §414(p). Legend will forward a sample QDRO containing the alternatives mentioned above to help ensure that all options are considered before the court document is drafted.



Access bills and make changes to participant contributions online!

Employers using ADSERV's Billing Services (including Common Remitting Services) can now access their bills via the internet and make changes to participants' accounts online. It's convenient, and it improves processing time and accuracy.

When billing changes are submitted by an employer, the information is downloaded and stored in a "workfile" program on our AS/400 system. When the Employee Benefit Account Department receives the money relating to the employer's account, this bill will be pulled from the "workfile" program and processed.

Procedures on submitting checks remain the same.

A unique access code is required in order for each employer to use this system.

1. Call ADSERV at 1-800-749-4221 (other than NY) or 1-800-749-4321 (NY only) to receive your unique employer access code.
2. If you need technical help during the set-up process, or have any questions about using this process, call the appropriate phone number above and ask for Alejandra Salatino at ext. 718.



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