GEARING UP FOR ROTH CONTRIBUTIONS

Effective January 1, 2006, an employer may allow participants in a 401(k) plan to designate a portion of his or her salary deferrals as Roth contributions. As indicated in the attached announcement, the Roth contributions will be treated like pre-tax deferrals in many ways. The one significant difference is that distributions of Roth contributions and the earnings on Roth contributions are tax-free, if the distributions meet certain requirements. There is a Roth calculator on our website (http://www.mcak.com/resources.asp). It will help a participant analyze the difference between pre-tax contributions and Roth contributions.

The IRS has issued proposed regulations on Roth contributions to 401(k) plans. They hope to issue final regulations soon. Roth contributions are also permitted in 403(b) plans. Similar rules are expected to apply, but the IRS has not yet issued any guidance on 403(b) plans.

If you want to add Roth contributions as an option to your 401(k) plan, you need to take the following steps:

- If you are considering implementing Roth contributions by January 1, 2006, notify your McCready and Keene consultant by October 15, 2005.
- Work with your payroll provider to revise the payroll system to differentiate between Roth contributions that are included in taxable income and pre-tax deferrals that are not. The revision to the payroll system needs to be in place by the first payroll in 2006 that will include Roth contributions.
- Arrange for communication to your employees either through meetings, written materials or both.
- Distribute revised election forms for participants to elect Roth contributions and/or pre-tax deferrals prior to the first date that Roth contributions are permitted.
- Sign plan amendment authorizing Roth contributions.
- Distribute Summary of Material Modifications to participants.
- Revise distribution forms.
- Separately report Roth deferrals and pre-tax deferrals on W-2 forms for 2006.

401(k) REGULATIONS UPDATED

The IRS has issued new 401(k) regulations which incorporate all of the changes since the regulations were last updated in 1994 and add a few new rules. The new rules are effective for plan years beginning on and after January 1, 2006. This article highlights the provisions most likely to affect our clients.

- **Gap period income.** If a plan fails its ADP or ACP test, the corrective distributions to the highly compensated employees must include earnings for the "gap period." The gap period is from the end of the plan year being tested to the date of distribution. This rule only applies if earnings would have been applied to a distribution during the gap period. That means the gap period rule applies to daily valued plans, balance forward plans that credit trust earnings to distributions, and balance forward plans with a normally scheduled valuation date during the gap period (for example, a plan with quarterly valuation dates that distributes excess contributions after March 31). An alternative to calculating the actual earnings is to apply 10% of the earnings on the participant's deferrals for the year being tested to each month in the current year until the distribution is made. This new rule applies to corrective distributions that occur in 2007 for excess contributions that are made during the 2006 plan year.

- **Aggregation for some highly compensated employees (“HCE”).** If a company is in a controlled group and an HCE participates in more than one plan in the controlled group, the HCE's compensation and contributions must be aggregated for purposes of ADP and ACP testing. This requirement exists under current rules.

- **12 month year for safe harbor plans.** The ADP and ACP safe harbors generally require a 12 month plan year. There are some exceptions that allow the safe harbor to apply to short plan years. Changing plan years or terminating safe harbor plans will require a close look at the rules.

[This article is continued on the back of this newsletter.]
SCHEDULE FOR RESTATING AND SUBMITTING PLANS

The IRS recently announced the schedule for restating and submitting individually designed plans, volume submitter plans, and prototype plans.

Individually Designed Plans

Generally, under the new procedure individually designed plans only need to apply for an updated IRS determination letter once every 5 years. Prior to submission, the plan needs to be restated to comply with the changes in law since its last submission. Each individually designed plan's 5-year cycle will be based on the last digit of the sponsor's EIN, as follows:

<table>
<thead>
<tr>
<th>Last digit of sponsor's EIN</th>
<th>Cycle</th>
<th>First cycle</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 or 6</td>
<td>A</td>
<td>February 1, 2006 – January 31, 2007</td>
</tr>
<tr>
<td>2 or 7</td>
<td>B</td>
<td>February 1, 2007 – January 31, 2008</td>
</tr>
<tr>
<td>3 or 8</td>
<td>C</td>
<td>February 1, 2008 – January 31, 2009</td>
</tr>
<tr>
<td>4 or 9</td>
<td>D</td>
<td>February 1, 2009 – January 31, 2010</td>
</tr>
<tr>
<td>5 or 0</td>
<td>E</td>
<td>February 1, 2010 – January 31, 2011</td>
</tr>
</tbody>
</table>

Special rules for individually designed plans:
- Multiemployer plans (plans maintained under a collective bargaining agreement with more than one employer contributing) are on Cycle D.
- Multiple employer plans (plans maintained by employers who are not in a controlled group/affiliated service group) are on Cycle B.
- Government plans are on cycle C.
- If the employer is in a controlled group/affiliated service group, the plan uses the EIN of the sponsoring employer.

Prototype Plans and Volume Submitter Plans

Generally speaking, under the new procedure prototype plans and volume submitter plans will need to be submitted for an opinion letter every 6 years. Non-mass submitter sponsors of defined contribution prototype plans, such as McCready and Keene, must submit for an opinion letter by January 31, 2006. The IRS anticipates that it will take 2 years to review the prototype and volume submitter plans and that it will give employers approximately 2 years to adopt after the IRS approves all prototype and volume submitter plans. It appears that the window for employers to adopt the updated prototype or volume submitter plans sponsored by McCready and Keene will be 2008 and 2009.

All Plans

A plan may be submitted at a time other than its appointed cycle. However, the IRS has indicated that "off-cycle" submissions will be put at the end of the queue, which means the review could be substantially delayed. The plan will have to be submitted again during its next assigned cycle.

The IRS may continue to require that certain amendments for changes in the law be adopted throughout the cycle. The IRS will require operational compliance for changes in the law even if the plan does not have to be updated until its submission date. And, finally, any amendment to reflect an employer's discretionary change in plan design will need to be adopted by the last day of the plan year for which it is applicable.

If you have questions or would like additional information about the items presented in this newsletter, call your McCready and Keene consultant.

Employee Benefit News is not intended as legal advice. Readers should seek legal advice before acting on any of these subjects.

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Roth is Coming in 2006!

McCready and Keene has developed a Roth solution to keep your benefits package competitive!

After-tax Roth contributions that create tax-free earnings will be available to add to your 401(k) and 403(b) plans starting in 2006 (a plan amendment and a set-up are required). This option will add significant value for participants who do not want to pay distribution taxes, who want an additional option for estate planning, or whose income level currently disqualifies them from participating in a Roth IRA.

**Roth Features Include:**

- Tax-free earnings*
- Tax-free qualified distributions*
- No income limit on eligibility
- Diversification opportunities within a qualified plan
- Contribution limit three times higher than a Roth IRA ($15,000 in 2006)**
- Additional catch-up contributions available for those age 50 or older
- Participant option to elect all or a portion of their elective deferrals as a Roth contribution
- May be eligible for employer match
- Available as an additional account under a qualified plan

* Distributions must be qualified. To be considered “qualified” a distribution must be made after a participant reaches age 59½, becomes disabled, or dies and must be distributed at least five years after the first Roth contribution to the plan.

**Combined Roth & pre-tax contributions are subject to the annual deferral limit. Roth contributions are also included with pre-tax deferrals in ADP testing.