

Roth 401(k)

In 2006, 401(k) plans will be able to allow participants to make salary deferrals to a Roth 401(k) on an after-tax basis. That means that employees will be able to make Roth-type contributions for the first time. If an employer amends its plan to add the Roth 401(k) feature, participants will be able to designate their elective deferrals as either pre-tax (*i.e.*, traditional 401(k) or after-tax (*i.e.*, Roth 401(k)).

That opportunity raises a number of important questions:

- What is a Roth 401(k)?
- What are the advantages?
- What are the disadvantages?
- Should 401(k) plans allow Roth contributions?
- And if they should, what must be done?

To give you a preview to the answer to the *big* question, “Should traditional 401(k) plans allow Roth 401(k) contributions?” my opinion is that they can be a valuable feature for a plan. Certain types of organizations may be early adapters such as law firms, medical groups, and investment management firms.

What is a Roth 401(k)?

The new rules permit, but do not require, plans to offer participants the ability to make some or all (at the participant’s choice) of their deferrals on an after-tax basis. The benefit of paying taxes when the “Roth” deferral is made is that the deferral, together with its earnings, will be distributed tax-free . . . if the distribution is “qualified”. Further, a Roth 401(k) account can be rolled over to a Roth IRA and the tax-free nature can thus be preserved while the earnings compound even further.

The distributions are “qualified” if they satisfy the usual restrictions on 401(k) deferrals (death, disabled or, if plan provides, attainment of 59 1/2) and if at least five years has passed since the first Roth 401(k) deferral.

From a tax policy perspective and as a general rule, there is no economic difference between traditional 401(k) and Roth 401(k) accounts. That is, assuming that a participant has a finite amount to allocate between elective deferrals and income taxes on the Roth 401(k) (*e.g.*, a total of \$5,000 either way), and that tax brackets do not change, the ultimate after-tax benefit will be the same. However, if reality differs from those assumptions, then one or the other will prove to be better. For example, if income tax rates are higher in the future, then a Roth 401(k) deferral will produce better after-tax results.

The Roth 401(k) feature does not increase the total amount of deferrals that can be made. For instance, the traditional 401(k) and Roth 401(k) deferrals are added together, and the total cannot exceed the usual deferral limit (known as the 402(g) limit), which in 2007 will be \$15,500 or \$20,500 if you are 50 or older (a \$5,000 catch-up for participants who will be 50 or older by the end of 2007). That combined amount is also used for the discrimination or actual deferral percentage (ADP) tests.

What are the advantages?

Because the Roth 401(k) is funded with after-tax dollars, earnings can grow and be withdrawn at retirement tax-free. The Roth 401(k) may appeal to the following market segments.

- **High-income participants** – Single participants that made over \$110,000 and married couples that had a combined income of over \$160,000 are ineligible to contribute to a tax-free Roth IRA. There are no income limits for Roth 401(k) contributions.
- **Roth IRA investors** – Investors that like the Roth IRA can now contribute \$15,500, the 401(k) maximum, to a Roth 401(k). That is nearly four times the 2006 Roth IRA limit of \$4,000 (\$5,000 if age 50 or over).

- **Young participants** – Participants in a lower tax bracket who are in the 15% or 25% tax bracket and expect their income to increase in the future may want to consider paying their taxes now rather than at retirement when they may be in a higher tax bracket.
- **Participants who expect tax rates to rise in the future** – Participants that expect overall tax rates to rise by the time they retire may want to pay the tax now rather than later.
- **Estate planners** – The ability to roll over a Roth 401(k) to a Roth IRA will allow high-income earners to maximize their estate assets and avoid the mandatory distributions rules at age 70 ½. The tax-free status of the Roth IRA can be passed along to their heirs.
- **Participants seeking control and flexibility in tax planning for retirement** – Participants will have the flexibility to split their contributions between a traditional 401(k) and a Roth 401(k) and may have more options for withdrawal at retirement. During years when the income tax rate is high, retired participants can withdraw from their Roth 401(k) and from their traditional 401(k) when the marginal tax rates are low.
- **Participants seeking to lower taxes on Social Security benefits** – Roth 401(k) withdrawals would be excluded as taxable income when calculating the taxes from Social Security benefits.

What are the disadvantages?

- If a participant with a Roth 401(k) account takes a distribution that is not “qualified” during the initial five-year period, the participant’s earnings will be taxed.
- There will be an expectation that providers, financial representatives and enrollers properly explain and effectively educate rank-and-file employees about the Roth 401(k) feature and about the options they’ll need to consider.

Should 401(k) plans allow Roth 401(k) contributions?

- Most likely, Roth 401(k) accounts will be offered to accommodate employee demand. It may prove that the early adapters turn out to be organizations such as law firms, medical groups, and accounting firms.

And if they should, what must be done?

- The plan sponsor must amend its plan document, update its Summary Plan Description (SPD), and update its distribution forms and explanations.
- The recordkeeper must add a new type of account to its system and develop the forms and procedures for tracking the Roth 401(k) deferrals and their earnings, as well as for making tax-free distributions of those accounts.
- The plan sponsor must coordinate with its payroll services for the reporting of Roth 401(k) deferrals and withholding on the amounts deferred.
- The third party administrator (TPA) must have the procedures in place to capture the information and use it for testing (e.g., the 402(g) deferral limits and ADP discrimination).
- The provider, enroller or financial representative must provide the enrollment materials needed to educate employees on the advantages and disadvantages of Roth 401(k) deferrals. The enrollment and deferral forms also must be modified so that the employees can, if desired, make that election.

Conclusion

The Roth 401(k) has some great benefits and will appeal to a broad range of participants. For some participants, the tax advantages may increase their elective deferrals, which, ultimately, translate into participants who may very well be more than adequately financially prepared for their retirement. It will be interesting to watch what the next 12 months bring in terms of how popular the Roth 401(k) becomes and to see who is participating.