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Roth 401(k) — An Option in 2006

Roth 401(k) contributions will be an option for 401(k) plans beginning in 2006, according to recently issued IRS proposed regulations. The Pension Specialists recommends that all 401(k) plans add this feature to their plans as of January 1, 2006. Here's how the Roth 401(k) works.

Roth 401(k) Basics:

• Available for the first time in 2006

• Optional feature that any 401(k) plan can offer

• Available to both low and high income employees (unlike Roth IRA)

• Roth contributions are elective contributions:

- Irrevocably designated by an employee as Roth contributions at the time of deferral

- Treated by the employer as wages subject to applicable withholding requirements at the time the employee would have received the contribution in cash, and

- Maintained in a separate account under the 401(k) plan

• Separate accounting applies when the first contribution is put into the plan, and continues until the entire Roth account is paid out

• A "qualified distribution" (defined below) from a Roth account will not be subject to taxation

• Existing 401(k) accounts may NOT be converted to Roth 401(k) accounts

• If plan currently matches 401(k) deferrals, then the contribution formula will apply to Roth 401(k) contributions as well.

Nondiscrimination Requirements:

• Designated Roth contributions are subject to the same nondiscrimination limits as pre-tax deferrals, including:

- Annual dollar limit on deferrals—$15,000 in 2006 (this means elective deferrals and designated Roth contributions are added together in determining this limit)

- "Average Deferral Percentage" (ADP) test, but not the "Average Contribution Percentage" (ACP) test

- Overall contribution limits under IRC section 415

- Top-heavy rules under IRC section 416, and

- Catch-up contribution limit ($5,000 in 2006). This means the catch-up limit applies to a participant's combined pre-tax deferrals and Roth contributions

• For purposes of the ADP test, a plan is permitted to specify whether pre-tax deferrals or designated Roth contributions are returned first in the event excess contributions need to be returned. The plan can also allow the participant to choose which type of contributions they wish to have refunded first.

• Roth contributions that are distributed from the plan as excess contributions on or before April 15 of the calendar year following the calendar year of contribution are not taxed again. However, earnings on these contributions are subject to taxation.

• If excess Roth contributions are NOT distributed by April 15, they are taxed again, as well as the earnings.

Rollovers and Distributions

• A qualified distribution described below, from a Roth 401(k) account may only be rolled over to another Roth 401(k) plan that accepts rollovers or to a Roth IRA.

• Designated Roth contributions are treated as elective contributions, so distribution may only be made upon termination of employment, death, disability, retirement, or if permitted under the plan, attainment of age 59-1/2 or hardship. Although distributions are permitted for the above events, tax-free treatment is only provided for "qualified distributions".

• A "qualified distribution" is one that is made after age 59-1/2, or on account of death or disability, and is made at least 5 years after the date the first designated Roth contribution was made.

• Roth contributions are subject to IRC 401(a)(9) minimum required distribution rules.

Miscellaneous

• No forfeitures can be allocated to a Roth account.

• Roth contributions are always 100% vested.

• Matching contributions - if Roth contributions are matched, the matching contributions are made on a pre-tax basis and are taxed on distribution.

• Reporting - Roth contributions are reported on Form W-2, along with pre-tax deferrals; distributions are reported on Form 1099-R.

Roth contributions are:

• Available for investment direction by the participant.

• Available for participant loans.

• Taken in to account for the mandatory cash-out threshold.

• Subject to a "qualified domestic relations order" (QDRO).

• Not subject to the 25% employer deduction limit, and.

• Cannot be rolled over to a qualified plan (unless to another Roth 401(k)), IRA (unless Roth IRA), 403(b) or 457 plan.

Advantages to Roth 401(k) include:

• No income restrictions on who can contribute.

• Higher contributions and catch-up limits available when compared to a Roth IRA.

• Matching contributions available on a pre-tax basis.

• Tax-free distribution of earnings.

• If a participant's tax rate will be higher at time of distribution from the Roth 401(k) than at the time contributions were made, then contributing to a Roth 401(k) may be more advantageous than contributing pre-tax deferrals.

Disadvantages to Roth 401(k) include:

• Separate accounting requiring additional record keeping.

• Impact on administrative procedures could be significant, such as impact of tracking 5 year rule, corrective distribution elections, tax reporting, tracking combined limits, tax basis, hardship withdrawals, loan administration.

• Double taxation of return of excess contributions if not distributed by April 15.

• Need to compare cost of losing current tax benefits of pre-tax contributions against the benefits of tax-free buildup to determine if Roth would be to your tax advantage.

Steps necessary to add Roth 401(k):

• Plan must be amended to add Roth 401(k) feature.

• Revised participant payroll election forms must be distributed, indicating which type of contribution they are making.

• You must check with your payroll service to ensure that they can accommodate a Roth 401(k) "bucket".

• Once Roth 401(k) contributions begin, reporting to The Pension Specialists every pay period must keep these separate from pre-tax deferrals.

• The notice given to a terminated plan participant must be revised to include distribution rules relating to Roth 401(k) monies.

Although finalized document language is not yet available, expect further guidance from the IRS to be forthcoming. TPS will provide additional information as it becomes available. If you want to further discuss this topic with one of our consultants, please call Customer Service toll free by dialing: 815-394-5500.