

TRISTAR PENSION CONSULTING

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New Retirement Plan Options Coming in 2006: The Roth 401(k)!

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In 1997, the Internal Revenue Code was amended to permit individuals to make contributions to a new type of IRA called a "Roth IRA."

Contributions to a Roth IRA are included in an individual's income and, unlike distributions from a "traditional" IRA, distributions from a Roth IRA are not usually taxed. In 2005, an individual may contribute up to \$4,000 (\$4,500 if over age 50) to a Roth IRA.

Roth IRAs have become very popular because they allow individuals to save for their retirement without facing income taxes on their later withdrawals from their Roth IRAs.

Starting in 2006, the benefits of Roth IRAs will be expanded to 401(k) plans. This new feature is called a "Roth 401(k)."

WHAT IS A ROTH 401(K)?

A Roth 401(k) is a part of a traditional 401(k) plan. It allows a participant to make after-tax Roth 401(k) contributions to a plan and usually allows distribution of the Roth 401(k) contributions (and earnings) without any further taxation.

Roth 401(k) contributions must comply with all of the requirements that apply to "traditional" 401(k) plan contributions and, for distributions to qualify as tax-free, must also comply with a series of special Roth 401(k) rules.

BENEFITS OF A ROTH 401(K)

There are several reasons to consider a Roth 401(k):

ROTH IRA CONTRIBUTIONS ARE NOT AVAILABLE TO HIGHER PAID EMPLOYEES BUT ROTH 401(K) CONTRIBUTIONS ARE

Individuals earning over \$110,000 (\$160,000, if married) are not eligible to make Roth IRA contributions. However, Roth 401(k)s are not subject to these income limits. A Roth 401(k) creates a new opportunity for highly compensated employees and officers to save for their retirement and receive 401(k) distributions on an "after-tax" basis.

REDUCED FEES FOR EMPLOYEES

Employees currently eligible to make Roth IRA contributions often have small account balances that lead to the imposition of annual account fees that eat away at their retirement savings. Roth 401(k) plans may help employees save more for their retirement without reduction for fees.

HIGHER CONTRIBUTION LIMITS THAN ROTH IRAS

Many employees already contribute to Roth IRAs. However, the dollar limits that apply to Roth 401(k) contributions (\$15,000 in 2006) are far greater than the basic Roth IRA contribution limit (\$4,000 in 2006).

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LONG-TERM COMPOUNDING FOR YOUNGER EMPLOYEES

Younger employees who will not need their retirement savings until a date far in the future will be able to pay taxes on their contributions today and have them grow on a tax-free basis until their retirement. As a result, earnings on their contributions will compound over a long period without being taxed in the future. Whether or not a participant will benefit from a Roth 401(k) will vary on a participant-by-participant basis.

SPECIAL CONTRIBUTION RULES

There are a number of special rules governing contributions to a Roth 401(k) account:

ELECTION OF ROTH 401(K) CONTRIBUTIONS

The Roth 401(k) rules require that participants have the ability to elect between Roth and traditional contributions to their 401(k) plan. A participant must make an irrevocable election whether a contribution is a traditional, pre-tax contribution or a Roth 401(k) contribution before an amount is contributed to the 401(k) plan.

SEPARATE RECORDKEEPING

Roth 401(k) contributions must be tracked separately from other contributions to a 401(k) plan.

FORFEITURES

Forfeitures may not be allocated to Roth 401(k) accounts.

ALLOCATION OF GAINS, LOSSES AND EXPENSES

Gains, losses and plan expenses must be allocated between a participant's Roth 401(k) and other 401(k) accounts on a reasonable basis.

ROLLOVER ROTH 401(K) CONTRIBUTIONS

A Roth 401(k) plan may permit a participant to roll his or her Roth 401(k) accounts in other plans into a 401(k) plan permitting Roth 401(k) accounts. Separate recordkeeping will be required.

IRS CONTRIBUTION LIMITS

Roth 401(k) contributions are subject to the maximum contribution limit that applies to traditional, pre-tax contributions. As a result, in 2006, the maximum combined amount of Roth and pre-tax contributions will be \$15,000 (\$20,000 for participants over age 50 if a plan permits catch-up contributions).

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NONDISCRIMINATION TESTING

Roth 401(k) contributions are treated like traditional pre-tax contributions for purposes of applying the Internal Revenue Code nondiscrimination testing requirements. In addition, a Roth 401(k) feature must be made available to participants on a nondiscriminatory basis.

MATCHING CONTRIBUTIONS

Employer matching contributions on Roth 401(k) contributions may not be made as Roth 401(k) contributions and must continue to be made on a pre-tax basis.

SPECIAL DISTRIBUTION RULES

There are also a number of special rules governing distributions from a Roth 401(k) account:

REQUIREMENTS FOR TAX-FREE DISTRIBUTION

Roth 401(k) contributions and earnings on these contributions are only tax free if they are distributed because of a participant's reaching age 59½, a participant's death or a participant becoming disabled.

In addition, Roth 401(k) contributions may not be distributed tax-free within five years of a participant's first Roth 401(k) contribution to the plan or a predecessor Roth 401(k) plan.

VOLUNTARY ROLLOVER OF ROTH 401(K) DISTRIBUTIONS

401(k) plans are already required to allow participants to roll their 401(k) plan distributions over to another 401(k) plan or an IRA. Roth 401(k) contributions will be subject to the same rules, except that rollover distributions of Roth 401(k) contributions must be made to another Roth 401(k) or a Roth IRA.

MANDATORY ROLLOVER OF INVOLUNTARY 401(K) DISTRIBUTIONS

Since March 28, 2005, plans that automatically cash out small participant account balances under \$5,000 have been forced to automatically roll over a cashout valued between \$1,000 and \$5,000 to an IRA. These mandatory rollover rules also apply to cashed-out Roth 401(k) accounts valued between \$1,000 and \$5,000, except that these amounts will be automatically rolled into a Roth IRA.

REQUIRED MINIMUM DISTRIBUTIONS

Unlike Roth IRAs, where distributions do not have to begin during the Roth IRA owner's lifetime, Roth 401(k) accounts must be distributed according to the same minimum required distribution rules applicable to traditional 401(k) contributions.

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UNRESOLVED ISSUES

Although many of the basic rules governing Roth 401(k)s are clearly addressed by the Internal Revenue Code and existing IRS guidance, a number of additional open issues are expected to be addressed by the IRS in coming months. These issues include the following:

ROLLOVER CONTRIBUTIONS FROM ROTH IRAS

Many employers allow employees to roll their regular IRAs into their 401(k) plan. It is unclear whether a Roth IRA may be rolled into a Roth 401(k) plan.

LOAN DEFAULTS

Many 401(k) plans permit participants to request and receive loans from their 401(k) plan accounts. If a participant defaults on his or her loan, he or she is generally subject to income tax on the amount defaulted.

It is not clear whether a defaulted loan that was taken (either in whole or in part) from Roth 401(k) contributions will be taxed as a distribution or whether a defaulted loan may qualify for the tax-free treatment given to most Roth 401(k) distributions.

SUNSET PROVISION

Aside from issues to be addressed by upcoming IRS guidance, there is a potential longer-term issue for Roth 401(k)s—the statutory "sunset" of these plan provisions after 2010. Roth 401(k)s were added to the Internal Revenue Code in 2001 with a January 1, 2006, effective date. However, they are due to automatically "sunset" after 2010.

If Congress does not extend or eliminate this sunset, the IRS will need to issue additional guidance and Roth 401(k) plans will likely need to be amended again to discontinue future Roth 401(k) contributions.

IMPACT ON PLAN SPONSORS

Plan sponsors that elect to implement Roth 401(k) contributions will face a number of additional requirements and communications issues:

REPORTING AND WITHHOLDING OF CONTRIBUTIONS

An employer must report Roth 401(k) contributions on a participant's W-2. Also, because Roth 401(k) contributions are taxed, withholding taxes attributable to Roth 401(k) contributions must be withheld from a participant's income.

COMMUNICATION WITH PARTICIPANTS

Many employees will be familiar with the concept of after-tax contributions from their experience with Roth IRAs. However, for many other employees, Roth 401(k) contributions will be a new



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concept that will need to be explained to employees. Clear participant communications will be essential to avoid confusion among this group of employees.

Plan sponsors will want to tread carefully to limit the risk that participants will later assert that they were improperly directed to Roth 401(k) contributions over traditional, pre-tax contributions (or vice versa).

PLAN AMENDMENTS

Employers must amend their plan documents and update their summary plan descriptions to reflect the Roth 401(k) rules if they are going to make Roth 401(k) contributions available to their employees.

CONCLUSION

Roth 401(k)s are an exciting new feature that may benefit many employees. Although Roth 401(k)s are not permitted prior to January 1, 2006, there are a number of design and logistical decisions that will need to be considered before Roth 401(k) contributions are put into place.

An employer considering Roth 401(k) contributions should consult with its advisors and service providers to discuss what changes would need to be made to its plan document, summary plan description, other plan materials, service agreements, payroll systems and recordkeeping systems to implement the Roth 401(k) rules.

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