



Treasury Issues Proposed Regulations for Roth 401(k) Plans

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The Treasury Department has recently issued proposed regulations for establishing and administering Roth 401(k) accounts. Similar to the Employer Retirement Savings Account proposed by the Bush administration, Roth 401(k)s were introduced by the Economic Growth & Tax Relief Reconciliation Act of 2001 under new Code section 402(A) and will be available January 1, 2006. In essence, the proposed regulations allow accounts under a 401(k) plan that feature many of the tax characteristics of Roth IRAs, but require that such accounts be specifically authorized by the 401(k) plan document.

Some of the important features of Roth 401(k)s include the following:

- Prior to the time a Roth contribution is made to the plan, a participant must irrevocably designate which contributions are to be treated as Roth 401(k) contributions rather than pre-tax deferrals.
- Contributions to a Roth 401(k) account will be treated as taxable wages (subject to income tax and employment tax withholding) at the time of contribution, but distributions will be tax-free. The earnings on Roth contributions are also tax-free, as long as the participant has maintained the account for at least five years and distributions are made after the participant reaches age 59½, or upon death, disability, termination of employment or hardship.
- The plan must maintain the Roth contributions, withdrawals and investments in a separate account to which plan forfeitures cannot be allocated. Separate accounting must begin at the time a Roth contribution is made and must continue until the Roth account is completely distributed.
- For 2006, a plan participant may contribute a total of \$15,000 in combined pre-tax deferrals and Roth 401(k) contributions. Plan participants age 50 or older may make additional catch-up contributions of \$5,000 in pre-tax deferrals, Roth contributions or a combination of the two. Roth contributions and pre-tax deferrals both count against the annual limit on pre-tax deferrals.
- Although Roth contributions are made to a 401(k) plan with after-tax dollars, they are combined with pre-tax deferrals for nondiscrimination testing using the actual deferral percentage (ADP) test, rather than the actual contribution percentage (ACP) test that is used for after-tax contributions. If the plan fails the ADP test, a highly compensated participant who must receive

a corrective distribution may choose whether to receive a refund of pre-tax deferrals or Roth contributions.

- Roth contributions must be fully vested at all times and are subject to the same restrictions on in-service withdrawals as are applicable to pre-tax deferrals.

If a 401(k) plan offers Roth 401(k) accounts, participants will essentially have to choose between making pre-tax deferrals or Roth contributions. Each dollar designated as a Roth contribution will reduce by a dollar the amount available for pre-tax deferrals. In deciding if a Roth 401(k) account is an attractive option to offer plan participants, therefore, employers should consider the following advantages:

- Earnings on a Roth 401(k) account are tax-free, as long they are received after age 59½ or upon death, disability, termination of employment or hardship, while the earnings on pre-tax deferrals are taxable upon distribution. Therefore, a Roth 401(k) contribution may be more advantageous for a participant if the money will remain in the plan long enough that the tax savings on the tax-free earnings will exceed the tax savings from tax deferral on an equivalent pre-tax deferral and earnings.
- Because contributions to a Roth 401(k) account are taxed at the time of contribution, a Roth 401(k) account might be attractive for someone who believes that tax rates will go up in the future or who expects his own income to increase significantly over time, putting him in a higher tax bracket in the future.
- Roth 401(k) accounts might also be attractive for a higher-paid employee, depending on his tax bracket and the number of years until his retirement, who wants to contribute to a Roth IRA but is precluded from doing so by the Roth IRA income limitations, which begin at \$95,000 for single individuals (phasing out at \$110,000) and at \$150,000 for married individuals (phasing out at \$160,000).
- Roth 401(k) contributions are subject to the required minimum distribution rules. A plan participant must begin receiving distributions from his 401(k) account (including his Roth 401(k) account) by April 1 following the year in which he reaches age 70½. He can plan around these requirements by rolling over contributions from the Roth 401(k) account to a Roth IRA, which is not subject to required minimum distribution rules while the participant is living.
- Unlike Roth IRA contributions, Roth 401(k) contributions may be eligible for employer matching contributions if the 401(k) plan so provides.
- Unlike Roth IRAs, Roth 401(k) accounts may not be subject to account fees under the plan sponsor's arrangement with the plan trustee, or the plan sponsor may choose to pay any fees directly or use plan forfeitures to pay the fees.

There are also disadvantages to Roth 401(k) accounts. Those contemplating adding a Roth 401(k) account as an investment vehicle should consider the following:

- Because Roth 401(k) contributions are made on an after-tax basis, individuals are taxed currently on the contribution. This means that less money is going into the retirement plan currently in comparison to pre-tax deferrals. If the money will not remain in the account long enough for the tax-free earnings to exceed the tax-deferred earnings that a pre-tax deferral would generate (net of tax), a pre-tax deferral might be a more attractive option.
- Because income tax rates are graduated based on income, if an individual's anticipated tax bracket upon retirement will be lower than his current tax bracket while he is working, he might fare better by making pre-tax deferrals, taking the tax break now and deferring taxation until he is in a lower bracket.
- The separate accounting and special tax rules that apply to Roth 401(k) accounts will require recordkeeping accommodations by the plan's service provider and the plan sponsor's payroll systems. The complexity of the tax rules for Roth accounts may also present participant communications challenges.

The Treasury Department is expected to issue guidance regarding the taxation of nonqualified distributions of Roth 401(k) contributions.

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