ROTH 401(K) AND 403(B) PLANS

What are they?

The provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) allow for the creation of both Roth 401(k) and 403(b) plans, as of January 1, 2006. Like their counterparts—traditional pretax 401(k) and 403(b) plans—they are established by an employer and they allow eligible employees to save for retirement. The new Roth 401(k) and 403(b) plans, however, differ dramatically in terms of tax planning. As is the case with the Roth IRA, contributions are made to Roth 401(k)s and 403(b)s with after-tax deferrals. The after-tax contributions grow tax-free and, with a qualifying event, the distribution is tax-free.

Example: John is employed by a company offering a Roth 401(k). He earns $40,000 annually. If John decides to defer 10 percent of his pay into the plan, $4,000 will be taken from his pay, but John will still owe taxes on the full $40,000 annual salary. Conversely, if John were to defer 10 percent of his pay, or $4,000, into a traditional 401(k), his taxable income would drop to $36,000.

Contributions in general

Employee: Employees may elect to defer 100 percent of their salary—not to exceed $16,500—into a Roth 401(k) or 403(b) for 2010. Employees who are age 50 or older may make an additional "catch-up" contribution of $5,500 for 2010. Unlike the Roth IRA, there are no phase-out limits based on a 2010 adjusted gross income. The total combined contributions to traditional pretax plans and Roth plans for 2009 cannot exceed $16,500 ($22,000 if the participant is 50 or older).

Employer: To encourage employee participation, some employers offer to match employee deferrals under a specific formula. For instance, an employer may match 50 cents of every dollar deferred by the employee, up to a maximum of 10 percent of each employee's salary. The employer also can make discretionary contributions in terms of profit sharing.

It's important to note that with Roth 401(k)s and 403(b)s, only employee deferrals can be deposited into the accounts. If the employer decides to offer a match (or profit sharing), these contributions must be directed into a traditional pretax plan. Additionally, the combined contributions to an employee's account for 2010 (or accounts, if the employer offers more then one type of defined contribution plan) cannot be more than the lesser amount of either 100 percent of that employee's compensation or $49,000. Further, the maximum tax-deductible employer contribution is limited to 25 percent of the total compensation of all employees covered under the plan.

Continued >

In general, any employer is eligible to set up a Roth 401(k) plan

All organizations—except governmental entities—are eligible to set up a Roth 401(k) plan; however, these plans may be particularly attractive to employers who:

- Are willing to run a traditional pretax plan as well
- Have more than 25 employees
- Have a sufficient number of non-highly compensated employees who will defer a portion of their salaries
- Are willing to spend the time and money that a Roth 401(k) or 403(b) plan requires for plan design, administration, and communication

Advantages offered by Roth 401(k) and 403(b) plans

- Roth 401(k) and 403(b) plans allow employees to take an active role in saving for their retirement.
- Employers have a certain amount of flexibility in deciding if and how much to contribute. An employer can match all or a portion of the employees' deferrals.
- Tax advantages:
  1. Future tax planning strategies can be considered by deferring contributions into a Roth 401(k) or 403(b).
  2. Contributions by the employee accumulate tax-deferred and, upon qualified distribution, they are tax-free.
- Ease in saving for retirement:
  1. Employees are not required to defer into the plan; however, if they do, they can change the amount of their deferral, or even stop contributing altogether.
  2. Because employees make their deferrals through payroll deductions, they may find it easier to save. The money is "out of sight, out of mind."

Potential ways to access funds

- Employers may structure 401(k)s and 403(b)s to offer loan privileges, where employees can borrow up to 50 percent of their vested balance (not to exceed $50,000). (**Reminder:** All loans are required to bear a reasonable rate of interest and must not be offered in a discriminatory fashion.)
- Employers can also have provisions for hardship distributions for such reasons as education, medical, or funeral expenses; hurricane relief; purchase of and repairs to primary residence; and rent or mortgage payments required to prevent eviction or foreclosure of the participant's primary residence. (Some restrictions apply for hardship distributions.)

Continued >

Catch-up contributions

Employees who become age 50 (or are older than 50) before year-end are eligible to make a catch-up contribution. For plan year 2010, the catch-up contribution amount is $5,500.

Employees contributing to 403(b) plans who have 15 or more years of service with a public school, hospital, home health service, health and welfare agency, or church may be eligible for an additional catch-up contribution.

Drawbacks of the Roth 401(k) and 403(b) plans

- The employer will need professional assistance to establish and administer the plan.
- Like other qualified plans, a 401(k) plan is subject to reporting and disclosure requirements under the Employee Retirement Income Security Act (ERISA). Therefore, an employer will require professional assistance in establishing and administering a plan.
- Roth plans are not as advantageous as the traditional pretax plans for participants with high fluctuations in income, or for those with children and with family incomes generally less than $50,000 who already receive additional child tax credits.

Testing

- As with traditional 401(k) and ERISA-qualified 403(b) plans, ACP, ADP, and top-heavy testing are required.
- Unless it meets safe harbor nondiscrimination requirements, a 401(k) plan is subject to the "top-heavy" requirements of the IRS Code. A plan is considered to be top-heavy if (as of the determination date) the total sum of the accounts of all key employees (generally the owners and officers of the business) exceeds 60 percent of the total of the accounts of all employees. If the plan is top-heavy, the employer must make a minimum contribution of 3 percent of pay to the accounts of all non-key employees. In addition, the plan must meet specific vesting requirements.

Continued >

TAX COMPARISON BETWEEN TRADITIONAL PRETAX AND ROTH 401(K) AND 403(B) PLANS		
Participant is over 50; assumes an 8% annual return compounded annually over 20 years, based on an income tax rate of 28%	**Pretax**	**Roth plans**
Total Amount Available to Invest[1]	$22,500	$22,500
Federal Tax Paid at Time of Contribution	$0	$6,300
Actual Contribution Amount Made to Plan	$22,500	$16,200
Account Balance at Time of Distribution	$104,871.54	$75,507.51
Federal Tax Rate at Time of Distribution	**Net Proceeds**	
Lower – 23%	$80,751.09	$75,507.51
Same – 28%	$75,507.51	$75,507.51
Higher – 33%	$70,263.94	$75,507.51

1. Assumes extra $5,500 catch-up contribution for clients over age 50.

Income tax for the employer

If a business contributes via a match or profit sharing to the Roth 401(k) or 403(b) plan, it can deduct these contributions up to 25 percent of the total compensation of all participants. When calculating the maximum tax-deductible contribution, the maximum compensation base that can be used for any one plan participant is $245,000 in 2010 .

Employee deferrals

In addition to being subject to current income tax, employee deferrals are subject to social security and federal unemployment payroll taxes. Elective deferrals—but not nonelective employer contributions—are subject to payroll taxes under the Federal Insurance Contribution Act (FICA), Federal Unemployment Tax Act (FUTA), and Railroad Retirement Act.

Continued >

Distributions

Qualifying distributions: In order for a participant to receive a qualifying distribution from a Roth 401(k) or 403(b), two events must take place. First, it must be five years from the date of the participant's first contribution; second, the participant must become 59½, become separated from service, become disabled, or die; or the plan must be terminated.

Required Minimum Distributions (RMDs): Unlike Roth IRAs, participants in employer-sponsored Roth 401(k) or 403(b) plans will be required to take their RMD once they have attained age 70½, unless they are a 5-percent owner or less and still working for the company.

Please note: There are no restrictions from moving the balance in a Roth 401(k) or 403(b) into a Roth IRA prior to age 70½, thereby avoiding having to take any RMD.

In closing . . .

The Roth 401(k) is a great savings opportunity for many people, and not just for highly compensated employees. For individuals who expect to be in a higher income tax bracket at retirement, have a longer time frame until retirement, or who are skeptical about the future of the government's support programs, the Roth 401(k) can put you another step ahead in supporting your desired retirement lifestyle.