Will Plan Sponsors, Providers and Participants Be Ready?

By Darrin Yappen, CRPS, RFC;
R. Scott Harrison Jr., QKA; and Steve Curnutte

"Roth 401(k)" does not quite roll off the tongue…at least not yet. But with a street date of Jan. 1, 2006, chances are strong that industry professionals will find this new retirement vehicle as ubiquitous in the parlance of tax planning as "401(k)" or "IRA."

With the furor over social security reform choking financial columns, little noise has been made of this new Roth provision. But in a recent survey of 200 large companies by Hewitt Associates, 35 percent said they might add a Roth 401(k) option. In the crowded landscape of the retirement world, plan sponsors will be looking even more to their professionals for guidance and clarity.

The Roth provision as it applies to IRA accounts has been around since 1997, and the features are commonly known. Funded by after-tax dollars, the growth and the contributions are not subject to taxation upon qualified withdrawal. The new Roth provision as it applies to Roth 401(k)s simply blends this familiar feature into the company-sponsored arena. This hybridization is accompanied with two principal distinctions. First, Roth 401(k)s are available to everyone regardless of income, whereas Roth IRAs are only an option for individuals below the income threshold of $110,000 ($160,000 for a married couple). Second, the 2006 Roth 401(k) contribution limit is $15,000 plus $5,000 for the over age 50 catch-up provision (note that this is a combined 401(k) and Roth 401(k) contribution limit), whereas the Roth IRA contribution limit is only $4,000 plus $1,000 for the catch-up provision.

As companies contemplate a Roth 401(k) addition to their offerings, some common sense guidelines apply. Plan sponsors who choose to offer Roth contribution programs must amend their plan documents to add Roth provisions. Total contribution caps for highly-compensated employees within the plan still apply. In other words, contributing to a Roth 401(k) account for these folks is an "either/or" proposition, not an "and" proposition. Also, since pre-tax contributions can never be mingled with post-tax contributions, separate accounting is required and money cannot be moved back and forth. Loan provisions and hardship provisions that apply to a traditional 401(k) also apply to the Roth 401(k).

Because they are ineligible to invest in Roth IRAs, high earners may be particularly eager to evaluate this new alternative, but lower compensated folks may want to embrace the new provision as well, since they can contribute to both their Roth IRA and their Roth 401(k). Factor in the possibility that their Roth IRA may have higher administrative costs than their Roth 401(k), and the fact that Roth 401(k) contributions could still qualify for an employer match on the pre-tax side, and a compelling case starts to emerge.

Though this Roth 401(k) newcomer opens more options for retirement planning, the normal stratagems are still very much in play. On the one hand, since the Roth 401(k) distribution is not taxable income, it will lower taxable income in retirement. The Roth concept may even help increase estate assets by leaving an income-tax free inheritance for heirs. On the other hand, the Roth 401(k) contribution does not lower the employee's taxable income at the time the contribution is made. The ultimate question still persists: does the participant want the tax deduction today while having to pay taxes in the future, or does the participant prefer to pay taxes now and have tax-free income in the future; or perhaps some combination? The answer would presume some understanding of Congressional wisdom on taxation in the future, and there are no guarantees.

Mark Twain once quipped that, "Education consists mainly in what we have unlearned." Each major change to the retirement plan universe has played out in the market in fresh and unpredictable ways - and has usually required some

"unlearning" before moving forward. Since individuals cannot set up their own self-trusted Roth 401(k) (the new provision must stand on a corporate trustee platform or an insurance company contract), the need for professionals and employers to digest, assimilate and implement the provision is brought into sharp relief.

Some points for review:

- In a traditional 401(k) plan, employee contributions are made pre-tax, earnings grow tax-deferred, and the withdrawals are treated as taxable income. Roth 401(k) contributions are made after-tax, earnings are tax-free, and the withdrawals that take place after the fifth year of participation in the Roth 401(k) and after age 59 ½, are also tax-free.
- Roth 401(k) contributions are provided for under §IRC 402A as added by Section 617(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001(EGTRRA). This law and the related regulations are to apply for plan years beginning on or after Jan. 1, 2006 (effective for taxable years after Dec. 31, 2005).
- Contributions to both the traditional 401(k) and the Roth 401(k) are combined and tested together in the Actual Deferral Percentage Test (ADP). Both traditional 401(k) and Roth 401(k) contributions can be eligible for employer matching contributions with the Actual Contribution Percentage Test (ACP) applying to the total combined matching contribution.
- If you roll a Roth 401(k) into a Roth IRA, the Roth IRA does not have the requirement for minimum distributions at age 70 ½.
- In order for earnings to come out tax-free, the distributions must be made after age 59 ½ and occur five years after starting to participate in the Roth 401(k) account. This five-year requirement also applies to distributions as a result of death or disability. Earnings will be taxed if the distribution occurs prior to the completion of the five years inclusive of participation in a prior Roth 401(k).
- Even though the employer match may be based all, or part, on the Roth 401(k) contribution, the employer match will have to be tracked separately, as it will still be considered taxable income at the time of withdrawal.
- The Roth 401(k), as well as other EGTRRA conditions, are subject to the Sunset Provision. Without an extension, the entire EGTRRA bill will expire after Dec. 31, 2010. If the Sunset Provision does not change, presumably the Roth 401(k) contributions can be held in the account, but no further contributions can be made.
- Implementation of a Roth 401(k) will require some education. The requirement for separate accounts may add some expense. However, in a climate where the Roth 401(k) is optional and not required, employers may need to view the Roth provision as a powerful recruiting or retention tool at the very least. Ideally, the provision will be embraced as another powerful financial engine to help employees save for retirement.

So as politicians wrestle with reforming Social Security, the suggestion has been made to create an "Employer Retirement Savings Account (ERSA)" to replace 401(k)s, 403(b)s and 457(b)s. The proposed ERSA would allow participants to contribute up to $15,000 after tax; contributions would grow with earnings and distributions would not be subject to further federal income tax.

But a very similar plan type has been sleeping quietly in the tax code since 2001. It is called the Roth 401(k), and it arrives in January of 2006. ■

**Although this article focuses on Roth 401(k) programs, new Internal Revenue Code § 402A also provides that any employer eligible to maintain a 403(b) plan will be able to create a Roth 403(b) program as of Jan. 1, 2006.*

About the authors

Darrin E. Yappen, CRPS, RFC, is the regional sales director with American United Life Insurance Company® in Nashville, Tenn. He can be reached at 615/298-1818 or via e-mail at Darrin.Yappen@OneAmerica.com.

R. Scott Harrison Jr., QKA, is the regional sales director with American United Life Insurance Company® in Southern California. He can be reached at 310/640-9699 or via e-mail at Scott.Harrison@OneAmerica.com.

Steve Curnutte founded Nashville-based FinWorth Partners, which specializes in coordinating the design, implementation and maintenance of qualified retirement plans for physician practices, attorney practices, and other medium to large closely-held businesses. He can be reached at 615/386-7102 or via e-mail at steve@finworth.com.