

The Roth 401(k): Something for Employers and Employees to Consider

The 2006 calendar year is the first year that 401(k) plans permit employees to designate all, or a part of, their elective deferrals as Roth 401(k) contributions. The amounts so designated will be includable in the employee's income. A "qualified distribution" of a designated Roth contribution will be excludable from gross income. What does all of this mean?

The term "Roth" has been associated with retirement savings since the passage of the Taxpayer Relief Act of 1997. Contributions to Roth IRAs are nondeductible, and "qualified distributions" are not includable in the taxpayer's gross income. However, contributions to Roth IRAs are statutorily phased out such that individual taxpayers with "modified" adjusted gross income (AGI) in excess of \$110,000 and joint filers with AGI in excess of \$160,000, in a given year, are ineligible to make any Roth IRA contributions for that year. This AGI limitation does not apply to the Roth 401(k), and for that reason, the Roth 401(k) may be very attractive to corporate executives and other highly paid employees.

Does it make sense to add the Roth feature to your plan? Integrating a Roth 401(k) feature might be the right fit for some employers, but not for others. Many factors should be considered when making this decision. And from the other side, as a participant in your employer's plan that offers this benefit, should you continue to contribute on a tax-deferred basis or designate future contributions as Roth – or possibly both? Again, it depends, and several factors must be considered. Whether you are an employer deciding to add the Roth feature to your plan, or a participant weighing contribution options, the following outlines some of the issues that may influence your decision.

Employer Considerations. Employers will need to balance the potential popularity of this plan enhancement with the extra administrative burdens that undoubtedly will be associated with its implementation and administration. Some of the noteworthy challenges that employers will face include:

- ADP/ACP testing. There will be a significant impact on ADP/ACP testing. In fact, employees, rank and file, may end up *decreasing* their contributions so that their actual take home pay will not be reduced.
- Administrative issues. On the administrative side, enrollment forms, educational materials and payroll functions will require modification.
- Cost. Significant costs can be associated with the necessary plan amendments as well as the summary of material modifications that must be prepared and distributed.
- Uncertainty. As they say, nothing is certain but death and taxes. Unless Congress makes the Roth feature permanent, it is scheduled to expire on December 31, 2010.

Employee Considerations. Assuming an employee is given the opportunity to allocate all or part of his or her elective deferrals as designated Roth contributions, the employee must assess whether or not making such a designation is appropriate. Generally, such an analysis should compare the future cost of paying the federal income tax up front with the future benefit of enjoying a permanent tax savings on account earnings.

Employees attempting to determine whether it is in their best interest to designate some or all of their elective deferrals as designated Roth contributions should consider, among other factors, the following:

- The expected number of years before the account will have to be accessed. In general, the longer you have until retirement, the more Roth makes sense.
- The current "cost" of paying tax up-front on designated Roth contributions. Making contributions after taxes are deducted will reduce take-home pay. If the employee's contribution must be reduced to make up for the additional tax, a portion of the employer match, if any, may be forfeited.
- The expected rate of taxation at time of distribution. If rates at retirement are projected to be higher than during the working years, a Roth designation may be appropriate.

- Estate planning considerations. Minimum required distributions do not apply to Roth 401(k) assets if they are subsequently rolled over into a Roth IRA. This may be significant if asset preservation for heirs is important.

For some individuals, the best approach may be a combination of traditional pre-tax and designated Roth contributions. By contributing to both types of accounts, an individual can hedge against some of the unknown factors (such as future tax rates) that ultimately may determine whether a designated Roth contribution was financially prudent.

Unanswered Questions. The Treasury Department issued Proposed Regulations in March of 2005 clarifying some important issues. However, many questions remain. Some of these include:

- The treatment of participant loans and repayments in connection with plans that allow designated Roth contributions.
- The tax treatment (and excise tax treatment) of hardship distributions attributable to designated Roth accounts.
- The impact of designated Roth contributions on the administration and processing of qualified domestic relations orders.
- The effect, if any, of designated Roth contributions on Form W-2 and Form 1099-R reporting.
- The impact of the designated Roth contribution on a Cash or Deferred Arrangement (CODA) that includes automatic enrollment.

While the Roth 401(k) seemingly offers many benefits, it poses an equal number of questions for employers and employees. Proceed with caution – contact your benefits professional today.

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