VOL. 31, NO. 3 WINTER 2005

Employee Relations LAW JOURNAL

Employee Benefits

The Roth 401(k): Glitter or Gold?

Anne E. Moran

Senator William Roth, who died in 2003, was a relatively unassuming person (for a US Senator) who rose to become chair of the Senate Finance Committee. But unlike many other more flamboyant members of that body, Senator Roth's name will long be remembered as it is attached to a provision in the Tax Code named for him—the Roth IRA. The 2001 tax changes, commonly called EGTRRA,[1] expanded the Roth IRA to allow its use, from 2006 to 2010, in 401(k) plans. Financial advisors are touting the benefits and disadvantages of the "Roth 401(k)" contributions that will be permitted for 401(k) plans starting in 2006. Therefore, plan sponsors and administrators need to know whether to welcome this new feature into their 401(k) plans.

Background—Evolution from the Roth IRA

Starting in 2006, under new Section 402A of the Internal Revenue Code, 401(k) plans and 403(b) plans may permit participants to designate all or part of their employee contributions as after-tax "Roth" contributions. The IRS issued proposed regulations on Roth 401(k) arrangements in March;[2] final regulations are anticipated soon. A Roth 401(k) feature is not available for 457(b) plans.

After-tax contributions, sometimes called "thrift" contributions, have been part of retirement plans for a long time, and many 401(k) plans allow a choice of pre-tax or after-tax

Anne E. Moran is a partner at Steptoe & Johnson LLP in Washington, DC. She advises clients on executive compensation issues and on benefits issues arising under retirement, health, and other benefit plans. Over the course of her career, she has served as Tax Counsel for the Senate Finance Committee and on the ERISA Advisory Council for the Department of Labor. Ms. Moran may be reached at amoran@steptoe.com.

contributions even though after-tax contributions do not have the advantage of tax deferral on the contributed amount. Some participants find after-tax contributions attractive because they generally are not subject to distribution restrictions that apply to pre-tax 401(k) contributions (*i.e.*, restrictions on distribution before age 59½, severance from employment, or hardship), and their earnings, like those of pre-tax contributions, grow tax-free until distribution. Thrift contributions have been viewed by many as savings accounts.

Although it contains after-tax features, a Roth 401(k) is different. It is based on the concept of the Roth IRAs—a nondeductible, after-tax contribution in an individual retirement account. A key advantage of Roth IRAs is that earnings are distributed tax-free after a minimum holding period of at least five years. However, Roth IRAs are only available to individuals with incomes generally below $110,000 ($160,000 for married couples), and the maximum amount that can be contributed to the Roth IRA is reduced as income approaches these maximum levels.

Contribution and Distribution Limits of the Roth 401(k)

Beginning in 2006, a Roth 401(k) contribution may be made to a 401(k) plan that permits its use. Roth 401(k) contributions will be treated like after-tax contributions in that the amount contributed will, like a Roth IRA, *not* be excluded from income or be deductible. However, the Roth 401(k) has certain advantages over the Roth IRA. First and foremost, the Roth 401(k) may be offered to all without any income limit. This is the first time the Roth IRA tax advantages will be available to the high-paid. Second, assuming the nondiscrimination tests can be met, maximum annual Roth 401(k) contributions ($15,000 in 2006, and a "catch-up" contribution of $5,000 for those over 50) are significantly higher than for Roth IRAs ($4,000 in 2006 with a $1,000 catch up). The maximum dollar limit on a Roth 401(k) is the qualified plan "402(g) limit" that applies to any 401(k) deferrals. Thus, high-paid individuals who are now contributing the maximum amount as a pre-tax 401(k) deferral would have to forego all or part of that advantage to the extent they wanted to use the Roth 401(k). As discussed below, this maximum contribution amount could be limited by the nondiscrimination test.

If contributions to a Roth 401(k) are held in the plan for at least five years and are paid after the participant reaches age 59½, dies, or becomes disabled, such contributions plus their earnings will be distributed tax-free (unlike pre-tax 401(k) contributions and earnings). That five-year period is measured from the earliest of:

- The first taxable year for which the participant made a Roth contribution to the plan; or

- The first tax year the participant contributions were made to a former employer's plan, if such contributions were rolled over to the plan.

Thus, if rollovers to a plan are permitted, the five-year rule is, in effect, applied on an aggregated basis. Moreover, the five-year test starts in the first taxable year for which contributions were made. Thus, for example, a contribution made in July 2005 can be distributed in January 2010.

Note that the special five-year requirement for tax-free distributions of earnings applies without permitting the exceptions allowed in 401(k) plans for distributions upon severance from employment, death, disability, age 59½, or hardship. Distributions of Roth contributions could be made when such events occur without *qualification* problems, assuming the 401(k) plan permits them, but the ability to receive tax-free earnings will be lost unless the five-year requirement is met.

Roth 401(k) contributions are also subject to the minimum distribution rules. By contrast, Roth IRAs do not have to make minimum contributions during the holder's life (or that of his spouse who assumes the holder's account upon death), but must make minimum distributions at death. Some have suggested that Roth 401(k) participants can avoid a plan's required minimum distribution requirement by transferring the account balance to a Roth IRA if they are otherwise permitted to take a distribution from the plan during a participant's life. This "flexibility" may create some tax planning opportunities unless the IRS moves to restrict it.

In general, except for their special tax-free treatment at distribution, Roth contributions are treated like 401(k) contributions. As noted above, they will be subject to the maximum contribution limits for the taxable year (which, for 2006, will be $15,000, plus an additional $5,000 for "catch up" contributions). This maximum dollar amount is applied to the aggregate of all pre-tax 401(k) contributions, Roth 401(k) contributions, or a combination of the two. If a participant is in more than one plan, the contributions to those plans will be combined for this purpose. Like 401(k) elective deferrals, in addition to the requirements for tax-free distribution treatment, Roth 401(k) contributions are subject to the nonforfeitability and distribution restrictions on 401(k) contributions. Thus, they must be immediately vested, and may not be distributed until 59½, death, disability, or severance from employment.

Roth 401(k) contributions are treated like pre-tax 401(k) contributions for purposes of nondiscrimination testing, so presumably they must satisfy the average deferral percentage (ADP) test rather than the average contribution percentage (ACP) test. Roth 401(k) contributions are presumably combined with regular 401(k) contributions for this purpose. If a plan fails the ADP test used for elective deferrals, the plan *may* permit participants to elect which type of contributions (Roth or pre-tax) are to be refunded. Any earnings distributed will be taxable, as under the normal rules, with no 10 percent penalty unless distributed after March 15 of the following year. However, it may be difficult to make necessary distributions before March 15 if plans provide an election procedure after ADP testing is completed.

Since the ADP test is likely to be a major limitation for Roth contributions, plans may consider adopting a safe harbor method under 401(k)(12), which provides for an automatic pass if its conditions (a contribution or match level stipulated by the statute) are met. Although the IRS has not specifically stated that the safe harbor can apply to Roth contributions, it logically should be able to do so since the contributions are treated like elective deferrals.

Recordkeeping Rules for the Roth 401(k)

A plan that contains a Roth 401(k) feature must meet the following requirements:

- The participant must irrevocably designate the contribution as a Roth contribution before making the contribution to the plan;

- The employer must treat the Roth contribution as taxable wages, subject to FICA and wage withholding; and

- The plan document must authorize such contributions, and a separate account must be established and kept to track the designated Roth contributions and gains and losses. Under IRS proposed regulations, forfeitures and matching contributions cannot be allocated to these accounts. This apparently does not mean that Roth contributions cannot be matched; it merely means that any matching contributions would have to be accounted for separately from the Roth contributions.

An employer establishing a Roth 401(k) feature will have to discuss the process of keeping separate accounts with its recordkeeper. The separate accounts are needed to deal with the different distribution rules, tax rules, and rollover rules. Rollovers from a Roth 401(k) may only be made to Roth IRAs. The special Roth account will also have to keep track of when the first contribution was made for purposes of the five-year rule. The account may also have to track "basis" (*i.e.*, the previously taxed contribution) in the event of a nonqualified Roth distribution, where earnings must be taxed. The proposed IRS regulations are not clear on all of these points, and specifically request comments on distribution issues.

There are other preparations to make for the Roth 401(k). The IRS requires that before such deferrals are permitted, the plan document will have to be amended. New election forms must be drafted and provided. Communications regarding the availability of the Roth contribution and its advantages and disadvantages will need to be prepared. Nondiscrimination testing may have to be revised.

Is it Worth It?

Not all employees will benefit from the Roth IRA. Those who do not expect to be in a higher tax bracket at the time of distribution may not benefit if their predictions as to their income and tax rates are correct. For example, individuals just ending lucrative careers and expecting to be in a lower tax bracket at retirement may not ever want to use a Roth IRA or make Roth 401(k) contributions. But predicting tax rates is a difficult business. Many financial advisers are warning their older clients that due to the current compression of the tax rates, in many cases a person's marginal tax rate may not be significantly reduced when they retire, as they might expect.

Persons who are in a low tax bracket at time of contribution and who expect to keep the amounts in the plan and enjoy substantial earnings appreciation, such as younger individuals, may find the Roth 401(k) very attractive. It also adds another tax-planning feature for the high-paid, who may wish to mix and control the timing of their taxable and non-taxable retirement distributions. For example, many high-paid individuals may have substantial amounts of nonqualified deferred compensation that will be taxed at receipt. The ability to time the receipt of that nonqualified deferred compensation may be limited in part by the new rules governing the timing of nonqualified deferral elections under Section 409A of the Code.[3] The Roth 401(k) is part of a qualified plan that is not subject to such constraints.

It is likely that the availability of the Roth 401(k) will depend on the expertise of plan recordkeepers and administrators and their willingness to begin such programs. The IRS has still not finalized the proposed regulations, and certain questions regarding distributions need to be resolved. Plan systems administrators are reluctant to install systems until the rules are clear, as changes are expensive. Thus, for many employees, the Roth 401(k) may not be available for 2006 implementation.

Plan administrators should also keep in mind that the Roth 401(k)'s features are a temporary part of the Code–they are now scheduled to "sunset" after 2010. Although Congress would likely not penalize the Roth 401(k) contributions already in place, this sunset feature means that the opportunity for the high-paid to enjoy the benefits of Roth contributions may be limited. This might encourage plan administrators to add these features as soon as possible, despite record-keeping hassles. But plan administrators who are considering adding a Roth 401(k) account need to balance the new flexibility available to participants with the recordkeeping burdens and potential costs.

Notes

1. P.L. 107-16.

2. *See* Prop. Reg. § 1.401(k)-1(f) at 70 Fed. Reg. 10062 (March 2, 2005).

3. *See* Anne E. Moran, "Deferred Compensation Legislation Casts a Wide Net–All Employers Need to Review Their Severance, Employment, and Compensation Arrangements," Vol. 31, No. 1, *Employee Relations L J.*102 (Summer 2005).

Reprinted from *Employee Relations Law Journal*, Winter 2005,
Volume 31, Number 3, pages 97 to 101, with permission from
Aspen Publishers, Inc., a Wolters Kluwer business, New York, NY, 1-800-638-8437,
www.aspenpublishers.com.