JENNINGS LAW FIRM

memorandum
February 9, 2007

ROTH 401(k) PLANS

Traditional 401(k) plans permit employees to contribute a portion of their wages to the plan and exclude those contributions from their federal taxable income. The employee (or beneficiary) then pays federal income taxes on the contributions and earnings when withdrawn from the plan. 401(k) contributions are not tax-free contributions; they are tax-deferred contributions. Similarly, the earnings on those contributions are not tax-free earnings; they are tax-deferred earnings.

Beginning on January 1, 2006, 401(k) plans may be amended to permit employees to characterize some or all of their traditional 401(k) contributions as Roth contributions. This memorandum describes some of the rules governing Roth contributions to 401(k) plans.

Is a Roth 401(k) Plan a separate kind of 401(k) plan?

A Roth 401(k) plan is NOT a separate kind of 401(k) plan. An employer who maintains a traditional 401(k) plan still maintains the same plan. The employer needs to amend the plan to permit employees to characterize some or all of their regular 401(k) contributions as Roth contributions.

What are the consequences of permitting employees to make Roth contributions to the plan?

Roth contributions are includible in the employee's federal taxable income for the year the contribution is made. This is unlike the treatment for traditional 401(k) contributions. Roth contributions, like traditional 401(k) contributions, are includible in the employee's FICA/Medicare wages for the year of contribution.

What are the advantages of making a Roth contribution?

Earnings on Roth contributions are excludible from the employee's (or beneficiary's) federal taxable income when withdrawn from the plan. [The contributions themselves are also excludible from gross income when withdrawn.]

By electing to include a Roth contribution in taxable income in the year of contribution to the plan, the employee (or beneficiary) will never pay any federal income taxes on the earnings in the Roth account.

Earnings on Roth contributions are tax-free provided they are distributed from the plan after the employee has maintained a Roth account in the plan for at least five years and distribution is made after the employee attains age 59½ or on account of death or disability. Termination of employment is NOT a qualifying event for this purpose.

Which employees are eligible to make a Roth contribution?

Unlike contributions to a Roth IRA, there are no income limitations on who can make a Roth contribution. Thus, all employees who are eligible to make 401(k) contributions to the plan may be permitted to make Roth contributions.

Can an employee make a Roth contribution in addition to a traditional 401(k) contribution?

An employee's combined Roth contributions and traditional 401(k) contributions cannot exceed the annual dollar limit on 401(k) contributions. Thus, each dollar of Roth contribution reduces dollar-for-dollar the employee's traditional 401(k) contribution limit.

For 2006, the 401(k) contribution limit is $15,000 and if the employee is age 50 or older at anytime during the year, a $5,000 catch-up contribution can be made. If an employee who is age 30 elects to make a Roth contribution in 2006 of $15,000, he/she could not make a traditional 401(k) contribution. However, if the employee elects to make a $10,000 Roth contribution for the year, he/she can make a traditional 401(k) contribution of up to $5,000.

How does the plan treat Roth contributions?

Roth contributions are treated like traditional 401(k) contributions for most purposes by the plan. For example, Roth contributions are combined with the employee's traditional 401(k) contributions for ADP testing and to determine if aggregate contributions for the year on behalf of the employee exceed the limits under IRC 415.

The plan must maintain Roth contributions, earnings and withdrawals in a separate account. Also, once a contribution is credited by the plan to a Roth account, that contribution cannot be changed to a traditional 401(k) contribution later on.

Why would an employee want to make a Roth contribution?

The question comes down to whether the employee is better off paying income taxes on the contribution up front in order to avoid paying any federal income taxes on the earnings later on. There are several factors involved.

- Can the employee afford to continue making his/her maximum allowable 401(k) contribution each year AND pay the income taxes on the Roth contribution? If the employee has to reduce his/her contributions in order to pay the income taxes, making a Roth contribution may not be advantageous.

  Comment: Our initial calculations show that employees who can afford to pay the income taxes on the Roth contribution up front realize higher net after-tax income by making a Roth contribution.

- If the employee has to reduce his/her annual 401(k) contributions to pay income taxes, would the employee lose out on any matching contribution available under the plan? If yes, making a Roth contribution may not be advantageous.

  Comment: Roth contributions must be eligible for any available matching contribution by the plan. Thus, an employer cannot use a Roth contribution option to the plan as a way to reduce its matching contribution.

- If the employee believes federal income tax rates are going to be substantially higher when the Roth account is distributed, making a Roth contribution may be advantageous.

- Roth accounts are subject to normal minimum distribution rules when an employee attains age 70½. An employee can avoid this by rolling his/her entire Roth account to a Roth IRA which is not subject to these rules.

  Comment: Don't be surprised if Congress closes this "loophole" before it gets too popular.

How do individual state income taxes figure into this?

Most states treat 401(k) contributions the same as under the federal Internal Revenue Code of 1986, but there are differences. For example, in Illinois traditional 401(k) contributions are not taxable when made nor are they taxable when paid out. Thus, in Illinois at least, contributions to 401(k) plans, including the earnings, are truly tax-free (not just tax-deferred). By making a Roth contribution, however, an employee is paying an Illinois income tax he/she would not otherwise have to pay. An employee needs to factor in his/her particular state tax laws when deciding whether to make a Roth contribution.

Are there any special rules I have to be concerned with?

When retirement plans are involved, there are always special rules to be concerned with. At the time this firm memorandum was prepared (November 2005) the IRS had issued proposed regulations providing some guidance, but there are many unanswered questions. We will update this memorandum as important new guidance is issued, but always check with our office before making any decisions about Roth contributions.

Many of the unanswered questions involve the distribution rules. We will need to await further guidance from the IRS on this and other outstanding questions.

How does an employer add a Roth contribution option to its 401(k) plan?

The plan has to be amended to accept Roth contributions. The IRS has indicated that these amendments do not have to be adopted until the last day of the plan year in which Roth contributions are first accepted by the plan. For example, a calendar year plan would have until December 31, 2006 to be amended if Roth contributions were accepted during 2006. As a practical matter, the amendments will need to be prepared right away since the employer is going to need to furnish summaries of material modifications (or new summary plan descriptions) and new administrative forms to employees to explain the changes. Also, employers are going to need to modify their payroll systems and their procedures for transmitting 401(k) contributions to the mutual fund or insurance company to differentiate traditional 401(k) contributions and Roth contributions.

We think employers may want to conduct employee meetings to roll out this change. There are going to be a lot of questions by employees about which option is better. Like most other retirement plan decisions, each employee's situation is somewhat different and each employee needs to consider his/her own particular circumstances. This is another example of the value of engaging a qualified and dedicated financial advisor who can help employees evaluate their own situations and make informed decisions.

How can our firms help?

If you are a client, we have prepared a package of all the documents you will need to add a Roth contribution option to your plan. Please call Lee T. Jennings in our office to order this package. A fee will apply.

For financial advisors, accountants and attorneys who advise their clients on retirement plan matters, we have prepared a slide show presentation that explains this new option. The slide show can be customized for your own use (including putting your firm's logo on the presentation). Also, we have developed an Excel worksheet that can be used to analyze the financial differences between traditional 401(k) contributions and Roth contributions under a variety of assumptions. This worksheet can be downloaded from our website at no cost.

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Jennings Law Firm and Dana Consulting Group are dedicated to being a resource to employers and their advisors to enable them to make informed decisions on designing and administering their qualified retirement plans. We provide no-cost consultations and in many cases will prepare no-cost proposals on designing (or redesigning) a plan.

If you would like additional information about retirement plans in general or Roth 401(k) plans, please call Lee T. Jennings at (312) 332-7733.

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