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EMPLOYER'S GUIDE TO UNDERSTANDING THE ROTH 401(k)

What is a Roth 401(k)?

Just as its name suggests a Roth 401(k) combines features of the traditional 401(k) with those of the Roth IRA. It is offered by employers just like a traditional 401(k) plan, but like the Roth IRA, contributions are made with after-tax dollars. With a Roth 401(k), participants do not get a tax deduction for retirement savings, but the withdrawals, including all of the profits that are made during retirement are tax free. In a Roth 401(k), income taxes are paid at participants' regular income tax rates at the time of contribution. Earnings and withdrawals are not taxed if withdrawals begin after age 59½, and if five years have elapsed from the date of the first contribution to the plan.

Why should you consider offering a Roth 401(k)?

The sole advantage of the Roth 401(k) to plan sponsors is the ability to offer additional retirement savings options to employees. Now that many larger companies have started adding Roth 401(k)s to their benefit packages, it behooves smaller companies to also start thinking about adding this option if they want to remain competitive. Adopting a Roth 401(k) may be a tremendous chance for you and your employees to add to retirement savings, because even those ineligible for Roth IRAs due to income caps are eligible to contribute to a Roth 401(k).

What you should consider before offering a Roth 401(k)?


When deciding whether to offer these plans, plan sponsors should consider:

- The Pension Protection Act has made the Roth 401(k) a permanent part of the benefits landscape.
- Much of the work required to support a Roth 401(k) feature will be handled by the plan's record-keeper, but the plan sponsor should consider whether their payroll systems are able to accept Roth 401(k) contribution elections and process the deductions.
- How to educate their employees about the Roth 401(k) in light of years of extolling the benefits of pretax savings.

What are the advantages of a Roth 401(k)?

- Current contributions are taxed but distributions including profits, are tax-free;
- No minimum distribution requirement at age 70½ if rolled to a Roth IRA prior to age 70½;
- Tax-free distribution to heirs upon death; and
- No income limitations – anyone can contribute to a Roth 401(k).

Are there disadvantages to the Roth 401(k)?

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- No current-year tax deduction. With traditional 401(k) contributions, participants receive reduced taxable income in the current year while with the Roth 401(k) plans, participants have to wait for any tax benefit.
 - It's hard to predict if one's tax bracket will be higher or lower in the future.
 - The Roth 401(k) does not consider a "first-time home purchase" as a qualified withdrawal, which means that participants may have to pay taxes if they try to use their Roth 401(k) dollars for an otherwise qualified first-time home purchase.

What are some of the rules associated with the Roth 401(k)?

- A worker's combined contributions to both traditional and Roth 401(k) plans cannot exceed \$15,500 (\$20,500 for employees 50 years of age and older) in 2007.
- Withdrawals of contributions and earnings are not taxed provided the account is held for at least five years, and withdrawals are made on account of disability, after death, or on or after attainment of age 59½.
- Employer matches are still made with pretax dollars, and the match will accumulate in a separate account that will be taxed as ordinary income at withdrawal.
- Early Roth 401(k) withdrawal rules will be subject to the same requirements as traditional 401(k) plans. Generally employees will have the same access to the funds that they have in their Roth 401(k) as they have to their funds in their traditional 401(k).
- Participants must take minimum distributions beginning the year after they turn 70½.
- The Roth 401(k) balance can be rolled over into a new employer's Roth 401(k) or into a Roth IRA if an employee leaves their job.

How does a Roth 401(k) compare to a traditional 401(k)?

The primary difference between the two is the way in which contributions are taxed. The contributions made to a traditional 401(k) account reduce the amount of income a participant has to report that year, resulting in a smaller tax bill. The participant pays taxes on those contributions plus all the investment earnings on those contributions upon withdrawal. There is no difference in investment opportunity between the two.

With a Roth 401(k), participant contributions do not reduce participant taxes in the year of the contributions, but all of the earnings in that account will be tax free as long as the account exists. At termination of employment, a participant can roll their account into a Roth IRA, and the earnings in that account will continue to grow tax free.

Comparison of the Roth 401(k) to the Traditional 401(k)

Characteristic	Roth 401(k) Account	Traditional 401(k) Account
Contributions	Employee elective contributions are made with after-tax dollars .	Employee elective contributions are made with before-tax dollars .
Income Limits	No income level to participate.	No income level to participate.
Maximum Elective Contribution	Aggregate* employee elective contributions limited to \$15,500 in 2007 (\$20,500 for employees 50 or over).	Aggregate* employee elective contributions limited to \$15,500 in 2007 (\$20,500 for employees 50 or over).
Taxation of Withdrawals	Withdrawals of contributions and earnings are <u>not</u> taxed provided it's a qualified distribution – the account is held for at least five years and withdrawals are made: <ul style="list-style-type: none"> • On account of disability, • On or after death, or • On or after attainment of age 59½. 	Withdrawals of contributions and earnings are <u>are</u> subject to federal and most state income taxes.
Required Distributions	Distributions must begin no later than age 70½, unless still working and not at least a 5% owner.	Distributions must begin no later than age 70½, unless still working and not at least a 5% owner.

*The contribution limitation is by individual, rather than by plan. Although permissible to split the annual employee elective contribution between Roth contributions and the traditional, pre-tax contributions, the combination cannot exceed the deferral limit of \$15,500 (or\$20,500) in 2007.



Who should consider the Roth 401(k)?

The answer to this question largely depends on what tax bracket a participant is in today, and what tax bracket the participant expects to be in upon retirement. If the participant is early in their career, making a fairly modest salary and anticipates being in a higher tax bracket upon retirement, the Roth 401(k) will appeal to them, because they are paying taxes on their contributions today at the lower rate and later will be able to withdraw that money without paying taxes.

Higher paid participants also can benefit from a Roth 401(k) because they are generally locked out of other savings vehicles that accumulate profits tax-free, and the Roth 401(k) allows them to reap the tax-free benefit. Higher paid workers generally do not have access to a Roth IRA, a popular retirement account for accumulating savings tax-free, because of income limits. The tax-free withdrawals can also help highly paid workers manage their tax situation in retirement.

For workers in their 40s and 50s, the choice may not be so easy. With the Roth, a participant will pay taxes up front when he or she is in a high tax bracket and then withdraw the money when they are in a lower tax bracket. Those who will be in a lower tax bracket during retirement are probably better off contributing to a pre-tax 401(k).

Furthermore, the longer the time before retirement, the greater the tax benefit, as participants are exempting more investment earnings from taxation. Many people today think that income tax rates are going to increase over the next 20 to 30 years and see the Roth 401(k) as a good hedge against those tax increases.