The Roth 401(k)

A Complementary Retirement Plan Solution

What is a Roth 401(k)?

Most people are familiar with 401(k)s and Roth IRAs. But chances are that many haven't heard of the Roth 401(k), a provision in the Economic Growth and Tax Relief Reconciliation Act of 2001 that takes effect on Jan. 1, 2006.

Section 402A of EGTRRA allows - but does not require - an employer to add a Roth contribution program to its 401(k) or 403(b) plan. Like the Roth IRA, the Roth 401(k) will be funded with an employee's after-tax dollars, and the employee may withdraw the contributions and earnings taxfree with a qualified distribution.

Who would use it?

Such accounts may appeal to employees who do not need to shift to a lower tax bracket currently, but want to avoid being taxed on withdrawals during retirement. Employees who want to be in a lower tax bracket, but also have tax-free income later, may choose to have both a 401(k) and a Roth 401(k), says James Farrell, senior financial advisor with Univest Corp. in Pennsylvania.

"If employees begin to do the math, these accounts look good for many people," says Lori Lucas, director of participant research at Hewitt Associates.

The employee who should consider a Roth 401(k), Lucas says, is one who believes that taxes in general will go up, which most think is likely; one who anticipates being in a higher income tax bracket in retirement; or one whose retirement income will be from earnings as opposed to contributions. The length of time before the account can be distributed relative to when the employee expects to retire should be contemplated as well.

Impact on Plan Sponsors

A recent Hewitt Associates survey of employer trends in retirement reveals that of the nearly 200 large companies polled, 35% of them may add a Roth 401(k) account to their defined contribution plan on Jan. 1, 2006. Offering Roth 401(k) accounts may enhance plan sponsors' recruiting and retention efforts.

"Hewitt is recommending to plan sponsors that they have both a 401(k) and a Roth 401(k), and that they offer a match on both," says Lucas.

The impact on the employer's match remains to be seen, but Frances King Quick, partner and practice team leader for the Adams & Reese LLP ERISA and Employee Benefits Team, notes, "Since designated Roth contributions are simply part of the employee's salary reduction election, it is likely that the employer's matching contribution formula will not change."

For employers considering Roth 401(k)s, "the first thing to do is understand what the timing is likely to be on offering these," Lucas says. "Then they need to get a sense of what the demand would be." Going forward, these accounts will generate more and more employee interest, she adds, so "plan sponsors should consider getting a game plan in place now."

As with most retirement options, communication will be a challenge. Employees will need to be aware of the regulations and restrictions before they opt for such an account. Lucas recommends that plan sponsors offer modeling tools and what-ifscenarios for employees; even the currently available Roth IRA calculators could give an employee an idea of potential retirement information.

Plan administration will be affected, too, because these Roth 401(k)s will need to be accounted for separately

from existing 401(k)s. "These will add another layer of administrative detail that employers will need to wade through, at least initially," says Farrell, who also believes that the process will "probably become seamless at some point."

"A further administrative hurdle," says Quick, "is that a 401(k) plan must take these contributions into account in performing its ADP testing on deferrals." Reprogramming the computerized systems to run this testing will add to the financial burden.

"In addition, Roth contribution accounts must be held in trust by a financial institution or another IRS-approved custodian," adds Quick. "Since ERISA permits a 401(k) plan to have noninstitutional trustees, adding the Roth contribution program may add trust expenses."

Rules for the Roth 401(k)

Accounts are funded with after-tax contributions (similar to a Roth IRA but different from the pre-tax contributions for 401(k) accounts). With a qualified distribution, the contributions and earnings are withdrawn tax-free. Qualified distributions must satisfy a five-year holding period - with plan rollovers, the time in the prior employer's plan is taken into account - and then one of three additional factors must be in effect: The employee turns 59 1/2, the employee becomes disabled, or the employee dies and the money is transferred to his beneficiary or estate.

Contribution limits are $15,000, with $20,000 allowed for workers 50 and older for catch-up contributions. (This is the same for 2006 401(k) contributions, but much more than the $4,000 limit for both traditional and Roth IRA accounts, which rises to $5,000 for workers age 50 or older.) If their employer offers a Roth 401(k), employees can choose to have either a 401(k), a Roth 401(k) or both - but the accounts must be kept separate, and the accounts can have a total of $15,000, not $15,000 in each.

If an employee leaves a company with which he has a Roth 401(k), he has the option of rolling over the account into another Roth account, whether it is an IRA or a 401(k), provided that the program permits rollovers. He can also leave it where it is, with the former employer. The Roth 401(k) is subject to the Sunset Provision: Without a Congressional extension, the entire tax bill will expire after Dec. 31, 2010.