



Understanding the New Tax Option

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The Roth 401(k) is a contribution option that retirement plan sponsors can add to their plans. This option gives employee-participants a choice as to how their salary deferrals — and retirement benefits — will be taxed.

The Roth 401(k) can provide your employees with more flexibility in their retirement planning. For some employees, making Roth 401(k) contributions instead of traditional pretax 401(k) deferrals may be very beneficial. At the same time, offering the Roth 401(k) option will require you, as a plan sponsor, to make some changes to your retirement plan and how it is administered.

In this booklet, we answer the major questions you may have about the Roth 401(k) and how it works. We also provide information on how to decide if offering the Roth 401(k) option is right for your plan and, if so, how we can help you add it in the most efficient and cost-effective way possible.

What is a Roth 401(k)?

The Roth 401(k) is an optional plan contribution type that first became available to retirement plan participants in 2006. With a Roth 401(k), plan participants can choose to have their salary deferrals made on an *after-tax* basis. This means that, unlike traditional pretax 401(k) deferrals (which are not taxed in the contribution year), Roth 401(k) contributions will be subject to current federal and, if applicable, state and local income taxes. So, Roth 401(k) contributions are subject to tax withholding like regular pay.

As with a traditional 401(k), any plan earnings on Roth 401(k) contributions are not taxed while the money is held in the plan.

However, when an employee withdraws Roth 401(k) money from the plan, the employee receives both the contributions and any plan earnings *tax free*, assuming certain tax law requirements are met. With a traditional 401(k), the pretax contributions and accumulated earnings are generally *taxed* on withdrawal at ordinary income-tax rates.

If the tax treatment of a Roth 401(k) seems familiar, it should be. Similar tax treatment applies to the very popular Roth IRA, which has been available for several years to individuals whose income is below certain levels. The new Roth 401(k) option makes most of the advantages of Roth IRAs available to *all* eligible plan participants within your retirement plan, no matter what their incomes may be.

Traditional 401(k) vs. Roth 401(k)		
Benefit	Traditional 401(k)	Roth 401(k)
Tax-deferred Contributions?	Yes	No
Treatment of Plan Earnings?	Tax Deferred	Tax Free*
Tax-free Distributions?	No	Yes*

* Tax law requirements must be met.

What are the tax law requirements for tax-free treatment of Roth 401(k) distributions?

Generally, distributions of Roth 401(k) contributions and any plan earnings on that money will not be taxed if:

- The money is distributed after the participant reaches age 59½ or on account of death or disability (as defined for Social Security disability purposes) *and*
- The withdrawal is made after five tax years have elapsed, starting with the year the first Roth 401(k) contribution was made.

If these requirements are not met, the Roth contributions still won't be taxed. However, distributions of Roth 401(k) investment earnings will generally be subject to income tax and, possibly, to a 10% tax penalty as well.

Why would an employee choose to pay taxes now rather than later?

For many employees, making Roth 401(k) contributions will mean more money in their pockets when they retire, after all taxes are paid. Depending on each

employee's individual situation, making Roth 401(k) contributions may be very beneficial, even with the upfront taxes. Generally, the decision will depend on several factors, such as the employee's:

- Current age,
- Expected retirement age,
- Current tax bracket,
- Expected retirement tax bracket, and
- Contribution amount.

The decision requires employees to consider their current situations, as well as what they expect their situations to be in the future.

Which participants might benefit from a Roth 401(k)?

- Younger and lower paid employees who would pay little tax on their contributions now and who have many years to accumulate potentially tax-free earnings.
- Employees who will be in the same or a higher tax bracket in retirement than they will be during their working years.
- Highly compensated employees who cannot contribute to a Roth IRA due to the tax law's income restriction.
- Employees who prefer (and can afford) to pay taxes now to gain tax-free treatment for their future plan withdrawals (and not take a chance that tax rates will be higher in the future).

Is offering Roth 401(k) mandatory?

No. A plan sponsor can decide not to offer Roth 401(k). Offering the new option is completely voluntary.

If my company offers the Roth 401(k) contribution option, can we still offer traditional pretax 401(k) deferrals?

Yes. In fact, for a plan to allow Roth contributions, it must allow participating employees to choose between

the two types of contributions. Whether an employee can choose to make *both* types of contributions at the same time will depend on the terms of your plan.

Our organization offers a so-called 403(b) tax sheltered arrangement. Can our 403(b) offer Roth contributions even if it isn't a 401(k) plan?

Yes. 403(b) plans are also eligible to offer Roth contributions.

Our 401(k) plan currently matches a portion of our employees' pretax deferrals. Are we required to match Roth 401(k) contributions, too?

Technically, no. However, many plan sponsors that offer Roth 401(k) may decide to match employee salary deferrals — pretax and Roth — the same way, no matter which type of contribution is made. This way, participants can freely choose which contribution type is best for them without concern for whether they'll receive a matching contribution.

Note, though, that matching contributions based on Roth 401(k) contributions are not themselves treated as Roth contributions. Roth 401(k) matching contributions will be tax deferred until distribution, at which time they will be taxed as ordinary income to the employee.

Note, too, that, if participants elect to “net” their Roth contributions (i.e., if they decide to reduce the amount going into the plan by the amount of income taxes payable upfront), then the amount the plan sponsor needs to contribute as matching contributions may be smaller than with full pretax contributions.

Are the contribution limits for Roth contributions the same as for traditional pretax contributions?

The current tax law dollar limit is \$16,500 for all salary deferrals, whether they are Roth or pretax. For those age 50 and older, additional “catch-up” contributions of up to \$5,500 are permitted. So, for example, the limit for a 55-year-old would be \$22,000 of total salary

deferrals, whether Roth, traditional pretax, or a combination. Your written plan document may call for lower limits.

401(k) Contribution Limits		
Contribution Type	Annual Contribution*	Catch-up Contributions*
Pretax Deferrals Only	\$16,500	\$5,500
Roth Contributions Only	\$16,500	\$5,500
Combination of Pretax/Roth	\$16,500	\$5,500

* Future contribution limits may be adjusted for inflation.

Do the tax law's nondiscrimination rules for 401(k) plans apply to Roth 401(k) contributions?

Yes. Roth 401(k) contributions must be counted along with other contributions when testing the plan for purposes of the existing rules that prevent a plan from discriminating in favor of highly compensated employees.

What about the tax rule that requires minimum distributions to be made from a qualified retirement plan starting at age 70½? Does that rule apply to Roth 401(k) contributions?

Yes. Unlike with a Roth IRA, Roth 401(k) money is subject to the minimum distribution rule. However, unless the current law is changed, the rule is easily avoided by “rolling over” the Roth 401(k) contributions and earnings to a Roth IRA before reaching age 70½. Then, the Roth IRA's no-minimum-distribution feature will apply.

What benefits does offering Roth 401(k) provide my company?

First, you'll be providing all employees — including

higher paid employees and owner-employees — more flexibility in how they save for retirement.

Second, offering Roth 401(k) contributions may encourage more lower paid employees to participate in your plan (especially those already contributing to a Roth IRA). Higher participation makes it easier for your plan to satisfy the nondiscrimination tests mentioned above.

Third, adding the Roth 401(k) option to your plan is relatively painless. But there are likely to be some “costs,” both in the form of additional administrative efforts and added expense. We’ll discuss the steps you need to take to add Roth 401(k) to your plan later in this booklet.

What is the downside?

One requirement for offering Roth 401(k) is that Roth money must be kept separately from the other assets in your retirement plan. The IRS has said this can be done by separately designating Roth contributions and earnings in a participant’s plan account, much the same way as different contribution types are accounted for now (e.g., salary deferrals versus employer contributions). Gains and losses will have to be allocated among the contribution sources. The recordkeeper for the retirement plans we service can handle Roth contributions as a separate contribution source.

Similarly, payroll systems must be adapted to separate Roth contributions from other plan contribution types. For most plan sponsors that use outsourced payroll services, this should not be a major issue (although some added expense may be involved).

However, for employers who maintain their own payroll systems, this requirement will necessitate changing the payroll system to accommodate the Roth contributions. Talk with your accountant or payroll system provider about what would be needed to make your system Roth 401(k)-ready.

Finally, plan sponsors will need to adopt a plan amendment allowing the plan participants to make Roth 401(k) contributions. While this requires addi-

tional paperwork, it should not be an overly burdensome process.

I’ve heard that Roth 401(k)s are only going to be allowed for a limited time. Is that correct?

No, it isn’t. Under the 2001 tax law that created Roth 401(k)s, Roth contributions were only to have been allowed through the end of 2010. However, Congress subsequently made Roth 401(k)s permanent in the pension reform legislation that was enacted in 2006. So, unless the law changes again, Roth 401(k)s are here to stay.

Suppose that we are convinced that offering Roth 401(k) is right for our company and our employees. What do we do next?

First, you need to notify us of your intention as soon as possible. We will then provide you with the paperwork needed to get the Roth 401(k) option added to your plan. If your plan document is sponsored by our organization, we will provide you information about how to amend your plan to add Roth 401(k) provisions and when that amendment needs to be made. (If we are not your plan’s document sponsor or you have an individually designed plan, you will need to see your document sponsor or professional advisor about getting your plan amended.)

Next, we will help you communicate with your employees about this new retirement plan feature. We will help you tell them about the potential benefits of making Roth contributions and what Roth 401(k) can mean to their future retirement plan balances. Since not all employees can benefit from Roth 401(k), we will stress the need for them to look at their personal situations before making any decision and, if needed, talk to a qualified professional.

Finally, we will help you implement a process for employees to elect to make Roth contributions. Our goal is to make this process as smooth as possible for you and your employees.

And what if our company chooses not to offer Roth 401(k) contributions at this time?

Just do nothing. If you want to add the Roth 401(k) option later, all you have to do is let us know, and we will work with you on implementing your decision.

The Decision Is Yours

The Roth 401(k) is an exciting new option that can give participants considerable tax-planning flexibility. However, plan sponsors have much to consider in deciding whether to offer the Roth 401(k) option or not. Sponsors will want to weigh the effort required to implement the change (and any resulting costs) against the benefits to the plan and its participants.

As your plan's service provider, we stand ready to help you understand the Roth 401(k) option and how it would affect your plan's operation. If you decide to proceed with offering Roth 401(k) contributions, we will help you implement the necessary changes and communicate them to your employees.

To learn more about Roth 401(k) and implementing it for your plan, please contact us.

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