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ROTH 401(k) PLANS: ARE THEY WORTH THE TROUBLE?

by
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You may have heard. Roth 401(k) plans come to life next year. This means employers with 401(k) plans may add a Roth feature as early as January 1, 2006. But should an employer do so? To answer this question one must weigh the administrative costs and employee confusion likely to result from doing so against the substantial financial benefits Roth accounts offer certain employees. Later in this newsletter we will address these competing considerations, but we will first describe what a Roth 401(k) feature is and review some of the pertinent rules applicable to those arrangements.

Traditional 401(k) Elective Deferrals. Under the current 401(k) rules, employees' contributions – or "elective deferrals" – are made on a "pre-tax" basis. This means amounts contributed by an employee are not subject to federal income tax (nor, typically, state income tax) in the year in which the contributions are made. When these amounts are ultimately distributed, both contributions and earnings are taxed at ordinary income rates.

Roth Contributions. Contributions made under a Roth 401(k) feature, like those made under a Roth IRA, are not excluded from the employee's income in the year in which the contribution is made. Instead, Roth contributions are currently includable in gross income. Why, then, might an employee choose to use a Roth feature? The answer comes at the back end. When distribution is later made, not only is the return of the employee's contributions free from federal income tax, earnings on those amounts are not taxed either. This favorable tax treatment on distribution is, however, only available for "qualified distributions."

A qualified distribution is a distribution that is made after the end of a specified "nonexclusion period" and that is (1) made on or after the participant attains age 59 ½, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled. The nonexclusion period is the five year period beginning with the earlier of (1) the first year for which the participant made a Roth contribution under the plan, or (2) if the participant rolled over a Roth contribution from another plan, the first year for which the participant made a Roth contribution under that prior plan. It is a bit unclear whether this five year period is based on calendar years or instead plan years, but later guidance will presumably clarify the point.

Administrative Complexity. The introduction of Roth 401(k) plans has made the recordkeeping industry cringe. That is because Roth contributions must be accounted for separately from pre-tax elective deferrals and other accounts (such as matching or profit sharing contribution accounts). Each employee's Roth contributions and withdrawals must be credited and debited to a designated Roth contribution account. Earnings and losses, as well as other credits or charges under the plan, must be separately allocated among a participant's Roth and other accounts on a reasonable and consistent basis. Forfeitures may not be allocated to a Roth account.

This separate accounting requirement adds a layer of complexity and burden for recordkeepers, without offering them the promise of larger contributions to offset their trouble. That is because the total amount an employee may contribute in pre-tax elective deferrals and Roth contributions is constrained by the same dollar limitations as apply to pre-tax elective deferrals alone ($14,000 for 2005; $15,000 for 2006, plus any permitted catch-up contribution). One consideration for employers deciding whether to add a Roth feature will, therefore, be the additional fees, if any, their recordkeeper will charge to support Roth accounts.

Roth Contributions Treated as Elective Deferrals for Many Purposes. Roth contributions are subject to most of the rules that currently apply to pre-tax elective deferrals. Not surprisingly, Roth contributions must be nonforfeitable. In addition, the distribution restrictions applicable to elective deferrals apply to Roth accounts. This means distribution may be made only upon (1) severance from employment, (2) death, (3) disability, (4) the attainment of age 59 1/2 (if the plan is a profit sharing or stock bonus plan), (5) hardship of the employee (again, if the plan is a profit sharing or stock bonus plan), or (6) in some circumstances, plan termination.

Where an employee has made both elective deferrals and Roth contributions, a plan may allow the employee to choose whether a particular distribution will be made from a Roth account or instead from other accounts. Rollovers of Roth accounts may be made to a new employer's Roth 401(k) plan or to a Roth IRA. Although it appears the required minimum distribution rules (the age 70 1/2 rules) apply to Roth accounts, a non-key employee can normally avoid application of those rules by rolling over his or her Roth account to a Roth IRA upon termination of employment, since the required minimum distribution rules do not apply to Roth IRAs. A key employee could do the same, but would need to do so before age 70 1/2 to avoid the commencement of benefits. For key employees working beyond age 70 1/2, required minimum distribution would need to commence at 70 1/2 for benefits not already distributed and rolled over to a Roth IRA.

Roth contributions are treated like pre-tax elective deferrals in applying the ADP test (which restricts the amounts highly compensated employees may contribute). As noted earlier, the Tax Code's dollar limitations on elective deferrals ($14,000 in 2005; $15,000 in 2006, plus up to $5,000 in catch-up contributions) apply, on an aggregate basis, to elective deferrals and Roth contributions. So, although a plan may permit an employee to choose whether contributions from his or her compensation will be made on a pre-tax basis (as an elective deferral) or instead as a Roth contribution (or, perhaps, a combination of the two), the total of the two amounts may not exceed $15,000 in 2006 (plus an additional $5,000, if the employee will attain age 50 by the end of the year in which the contribution is made and be eligible to make a catch-up contribution).

Who Would Want a Roth Account? There are a number of circumstances in which an employee would enjoy a financial advantage in designating 401(k) plan contributions as Roth contributions.

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- **Higher Tax Bracket at Distribution**. Roth contributions will be economically advantageous for employees who are in a higher tax bracket at distribution than at the time contributions are made. So, for example, younger employees who expect to move up in tax bracket as their compensation increases, or who are currently in lower brackets due to relatively large mortgage or dependent care deductions, are candidates for making Roth contributions. Higher bracket employees may also conclude that Roth contributions are advantageous because they may believe the tax rates for those with the highest taxable income are currently at historically low levels and are, therefore, likely to be higher when distributions are made. (If high income individuals believe as well that the gap between capital gains and ordinary income tax rates is likely to remain substantial, they may not even want to contribute to a 401(k) plan, preferring instead to enjoy capital gains rates on their investments outside a qualified plan.)

- **Lots of Money to Save**. For those able to save more than the dollar limit for 401(k) contributions, a Roth feature offers the opportunity to effectively save more dollars on a tax-favored basis. Take as an example an employee whose 401(k) contribution for 2006 is limited to $15,000 (because the employee is not old enough to make a catch-up contribution), and who is in an effective 40 percent income tax bracket (combined federal and state taxes). Let's assume this employee is able and willing to save $25,000 of his or her compensation. If the employee were offered a Roth 401(k) option, the employee could take one of two approaches. Under the first, the employee would contribute $15,000 on a pre-tax basis to his or her 401(k) account and invest outside the plan the remaining $10,000. Under the second approach, the employee would make a $15,000 Roth contribution. This would leave no monies available for investment outside the plan because the employee would need the entire $25,000 to net a $15,000 Roth contribution after reduction for taxes. The net effect of this second approach would be to save and invest the full $25,000 in discretionary compensation in the tax-favored 401(k) plan. This is in contrast to the use of pre-tax elective deferrals, where only a portion of the employee's savings attributable to his or her discretionary compensation would be contributed to the 401(k) plan. The balance would be invested outside the plan, and not in a tax-favored vehicle.

  If the employee in the example above has the same tax rate upon distribution as at the time of contribution, the employee will have more money, after the payment of all income taxes, if he or she uses the Roth contribution approach. This assumes the distribution from the Roth account is a qualified distribution. The reason is that earnings on the Roth contributions will *never* be taxed. In contrast, under the traditional 401(k) approach, earnings on monies outside the 401(k) plan will be taxed, although possibly at low capital gains rates (depending on how the monies are invested). Nevertheless, a zero percent tax on earnings is better than tax at a favorable capital gains rate!

  This advantage of using Roth contributions applies only to employees who can afford, and are willing, to save more than $15,000 of their compensation (before tax) in 2006. That is, the advantage described here does not apply where an employee cannot afford, or is not willing, to save more than the Tax Code's dollar limitation for 401(k) elective deferrals.

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- **Tax Diversification**. As noted above, if an employee will be in a higher tax rate at the time he or she receives distributions from a 401(k) plan, the employee will have more dollars, after the payment of income taxes, if the employee makes Roth contributions rather than traditional pre-tax elective deferrals. This is true whether or not the employee is able and willing to contribute more than $15,000 (for 2006) in elective deferrals. Because it is difficult, and perhaps impossible, to predict future tax rates, some experts advocate splitting employees' contributions between elective deferrals and Roth contributions, in an effort to "diversify" employees' tax risk. The wild card is how Roth accounts will be treated if the United States switches to a completely different taxation system, such as moving from an income-based taxation system to a national sales tax or value added substitute. In that circumstance, it is difficult to know how employees who made Roth contributions would enjoy the benefit of the tax bargain they made, since the payoff for Roth contributions comes in avoiding income tax upon distribution.

What to do? For many employers, it will be difficult to decide whether to add a Roth feature to their 401(k) plan. A Roth feature will add administrative complexity, although most of this will fall on the plan's recordkeeper. An employer will, of course, want to understand any additional charges its plan's recordkeeper will make for accommodating Roth accounts.

Probably more importantly, employers must carefully consider the complication a Roth feature will add to the decision making process for employees. If an employer's workers already have difficulty deciding whether to make elective deferrals and how to invest their contributions, adding a Roth feature may induce paralysis. It is possible that the addition of a Roth option will cause some employees not to make any contribution, where they would have made a pre-tax elective deferral otherwise.

Employers with automatic contribution features, under which employees are treated as electing to make a pre-tax elective deferral of a particular percentage of pay unless they affirmatively elect to the contrary, will probably want to continue to have those automatic contributions made in the form of pre-tax elective deferrals since this is the expectation that has been set for employees. Switching to automatic Roth contributions would raise a strong potential for misunderstanding and confusion.

Adding complication, the Roth 401(k) rules are set to expire at the end of 2010. This means unless Congress extends the availability of Roth contributions, those contributions can be made for only the next five years.

If an employer wishes to add a Roth feature to its 401(k) plan for 2006, it will need to make that decision soon and inform employees so they can make the appropriate contribution elections. Employers' plan documents will need to be amended to reflect the addition of a Roth feature, but not until the end of the plan year beginning in 2006. So, for calendar year plans, an amendment adding a Roth 401(k) feature will need to be adopted by December 31, 2006.

At bottom, it seems likely smaller employers and those with a financially sophisticated workforce may be the best candidates for the addition of a Roth feature. These employers can capture the real economic advantages of Roth contributions for their employees, while having a better opportunity than most to manage the attendant communications complications.

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