



New Roth Contribution Program Option Adds a Twist

As of January 1, 2006, nonprofits that offer their employees either a 401(k) or 403(b) plan will be able to offer a new type of retirement account — a "qualified Roth contribution program" — that allows Roth Individual Retirement Account-style contributions to a 401(k) or 403(b) plan without the restrictions that limit participation in a Roth IRA.

This twist will give employees the option of setting aside money from their paychecks that's already been taxed and saving it in a retirement account where it can grow tax-free.

And the good news is that this new Roth 401(k)/403(b) offers flexibility and potential benefits for virtually all employees. Employees who believe their federal income tax rate will be higher when they retire could certainly benefit. Likewise, lower-paid employees, especially younger staffers, could benefit from years of nontaxed growth under this option.

Some Background

As part of the Economic Growth and Tax Relief Reconciliation Act, Congress made some important changes to defined contribution plans: The rules governing 401(k) accounts were modified, contribution ceilings were increased, and "catch-up" options were created.

Included in these changes was the creation of a new type of retirement plan. The new plan combines elements of a traditional 401 (k) account and a Roth IRA.

Longtime observers are calling the debut of the Roth 401(k) further evidence of the government's "new thinking" about defined contribution retirement plans, and see it as an encouraging sign that Congress may continue to explore new ideas to make defined contribution plans more effective for employers and workers alike.

That said, it's important to note that the Roth 401(k) concept was created in a tax

bill that sunsets at the end of 2010. Unless Congress extends the act, participants will not be able to contribute additional money to the Roth after that time, although money already in the account would continue to grow tax-free.

The Nitty Gritty

The differences between traditional and Roth 401(k) contributions are similar to the differences between traditional and Roth IRAs. Traditional IRA and 401(k) contributions are made with *pre-tax* dollars and distributions are *taxable*. Roth IRA and Roth 401(k) contributions are made with *after-tax* dollars, and distributions are *not taxed*.

Putting it in: Unlike contributions to a Roth IRA, there are no participatory income limits for a Roth 401(k). For example, if a single person's adjusted gross income exceeds \$110,000 (\$160,000 for a married couple) he or she would be prohibited from putting money into a Roth IRA, but would be able to invest in a Roth 401(k).

For tax year 2006, the maximum contribution amount is set at \$15,000, with rates adjusted for inflation each year. Under a special "catch up" provision, individuals age 50+ may contribute an additional \$5,000 in salary deferrals beyond the \$15,000. Note that these totals apply whether the contributions are to a Roth 401(k), a traditional 401(k) or a combination of both.

Taking it out: When Roth money is withdrawn, both the contributions and earnings are tax-free if two conditions are met:

- (1) the withdrawal occurs after the age of 59½, or in the event of death or disability; and
- (2) the contributions have been in the account for at least five years.

The Roth 401(k) has the same distribution requirements as the traditional 401(k). Participants will need to begin taking minimum distributions by the time they reach age 70½. This contrasts with the Roth IRA, which has no distribution requirements.

The Challenges

Of course, not every organization and employee will jump on the bandwagon. In fact, your organization's plan is not required to offer a Roth feature. But if you do add a Roth contribution option to your 401(k) or 403(b) plan, you will undoubtedly experience a number of new accounting and recordkeeping requirements, including:

- Elective employee Roth contributions and any earnings on those contributions must be maintained in an account separate from any matching funds. This

means that, while an employer can match an employee's Roth contributions, those matching contributions are pretax and must be held separately. This can be done by designating Roth contributions and earnings separately in an employee's plan account, much the same way that different contribution types (salary deferrals and matching employer contributions) are accounted for now.

- Employee designations of a contribution as a Roth contribution cannot be altered and must be "irrevocable" when that election is made.
- Roth 401(k) accounts can be rolled over (upon retirement or termination) to a Roth IRA or to another 401(k) plan or 403(b) plan that has Roth deferral provisions.
- Roth contributions can be treated as catch-up contributions and may serve as the basis for plan loans. Employees whose plans have a loan option are allowed to borrow up to 50 percent of their vested account balance to a maximum of \$50,000.
- Roth contributions are subject to nondiscrimination testing rules.
- A "stand-alone Roth 401(k) plan" is not permitted. A 401(k) or 403(b) plan must provide employees with a choice between pretax (traditional 401 (k) or 403 (b)) and after-tax (Roth) contributions.

Contact our office today to discuss the feasibility of this exciting new retirement plan option at your organization and for guidance on making your payroll system "Roth-ready."

Roth or Traditional?

Actually, it's more a matter of "Do I want to pay now or later?"

Assuming that you're a 30-something in the 28 percent tax bracket, would you rather enjoy a \$1,400 tax break today on your \$5,000 401(k) contribution — and then pay taxes on your contributions plus all the earnings that accrue over

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personal financial situation to determine which option works best for you.

But, whatever you do, don't fall into an "analysis paralysis" trap and sit on the sidelines investing nothing for retirement because you can't make up your mind which option is best for you. If you can't decide, and are eligible to contribute to either type of account (and your plan allows it), you can always choose the middle ground and split your contributions between the two.