

INFORMATION FOR THE PLAN SPONSOR: SHOULD I ADD THE ROTH 401(k) TO OUR PLAN?

Please note, this information is based on the proposed regulations. Some of this information may change when the final regulations are issued.

Salary deferrals to a Roth 401(k) are made with after-tax dollars. In a regular 401(k) plan, salary deferrals are made on a pre-tax basis.

This means that when that the Roth 401(k) contributions are withdrawn (see below on when they can be withdrawn), no more taxes are paid – the contributions and their earnings are tax-free. Since regular 401(k) contributions are made on a pre-tax or tax-deferred basis, the contributions and their earnings are taxed as income when they are withdrawn.

This section address some common questions and concerns you may have in trying to decide whether to offer the Roth 401(k) in your plan.

If the Roth 401(k) is added to my plan, would it take the place of the regular 401(k) contributions?

No, in most cases, Roth is being added to the plan. Participants could put all of their contributions into the Roth, all of the contributions into the regular 401(k) or a combination of both. Participants can **not** switch money from one to the other after it goes in.

Nor can they double their contribution by having both types of 401(k) accounts. The same contribution limit applies to either account or to both combined.

Which of my employees would a Roth 401(k) most benefit?

There is no clear answer for this, since even tax experts disagree. Some experts think that the Roth 401(k) would most appeal to a highly-compensated employee whose income is too high for a Roth IRA, but anticipates being in a high tax bracket after retirement and would like the tax-free withdrawals then.

Other experts think that young employees in low tax brackets now would most benefit anticipating that their tax bracket will be higher after retirement. In other words, pay taxes while in the low bracket and withdraw the money tax-free when in a higher tax bracket.

Please remember, both of the above opinions assume that the tax laws that allow tax-free withdrawals from Roth 401(k) accounts will not be changed. Regarding this issue, Ted Benna, who is credited with devising the 401(k) plan, offered his opinion, “Can you trust the government for 30 years? My answer is no, you can’t.” (For a copy of the complete article, please contact our office.)

Obviously, if someone thinks that their tax bracket now is higher than they expect it to be at retirement, than the traditional 401(k) is a better choice. For the employee who thinks that their tax bracket will remain unchanged, a coin flip is as good a method as any to decide.

What else should be considered?

Someone contributing to a Roth 401(k) might have to make a smaller contribution than they would to a regular 401(k) because of the difference in the upfront tax cost. As an example, a participant who defers \$250 a month to a traditional 401(k) but only has a decrease in pay of \$200 because of tax savings. That same participant could probably afford to only contribute \$200 to the Roth 401(k).

Less deferrals means less money accumulated. To illustrate this point, let's look at an individual, age 35, who contributes a set monthly amount until age 65 and earned an average of 8% per year. If this investor only contributed \$200, he would have \$298,071 (tax-free) at retirement. If he contributed \$250, he would have \$372,590 (all taxable) instead. Once again, it would depend upon the individual's tax bracket before it can be determined if he is better off taking the lesser amount tax-free or paying taxes on the larger amount.

Will required minimum distributions still be required at age 70½ from a Roth 401(k)?

Yes, just like with a regular IRA and regular 401(k), you must take a minimum withdrawal each year beginning with age 70½.

However, under the proposed regulations, if the Roth 401(k) money is rolled into a Roth IRA, there are no required minimum distributions starting at age 70½. This allows someone who does not need the income to preserve it for their estate. Further clarification of this issue is expected from the IRS.

Will the Roth contributions have to be included in my plan's non-discrimination testing?

Yes, these contributions are subject to the average deferral percentage (ADP) test. In addition these contributions are a benefit, right and feature and **must** be offered to all eligible employees on a non-discriminatory basis.

But my plan is a Safe Harbor plan, will the Roth contributions still be tested?

It is the opinion of our document provider that the safe harbor rules apply to Roth contributions.

What happens if we have a failed test?

If refunds to the highly-compensated employees are required, the plan is permitted to specify whether pre-tax deferrals or designated Roth contributions will be returned first. Alternatively, the plan may allow participants to choose which contributions are returned first.

Will the Roth contributions be included in the top-heavy test?

Yes, Roth contributions are subject to the top-heavy rules.

Will my administrative costs increase if a Roth 401(k) is added to my plan?

Yes, administrative costs will be higher since the deferrals **and** the earnings have to be kept track of separately which requires additional recordkeeping.

There will also be a charge for providing the amendment, customized Summary of Material Modifications, revised enrollment forms and a revised Safe Harbor Notice (if applicable). Please contact our office for more information.

Other than cost, what other administrative issues should we consider?

In order for the contributions and earnings to be withdrawn tax-free a “qualified distribution” must be made. Contributions have to stay in the plan for at least five year (5-year aging rule) **and** the participant must be at least age 59½ in order for a “qualified distribution” to be made. This means tracking the 5-year aging which starts when the first Roth 401(k) contribution is made.

The Roth 401(k) will be another after-tax deduction for your payroll provider. If a participant is contributing to both the Roth and regular 401(k), careful monitoring will be required to ensure that the amounts combined do not exceed the regulatory limits.

Changes to website, enrollment kits, distribution forms and participant statements.

If the plan allows Roth contributions to be used for loans, hardship withdrawals or in-service withdrawals, changes in forms and procedures will be required.

Employee education may be difficult since there are no clear answers on whom a Roth 401(k) will benefit.

There are also open issues that still require IRS Guidance such as:

How the 5-year aging requirement will be applied to rollovers from a Roth IRA to a Roth 401(k).

Will the plan administrators be able to rely on participant information in the case of rollovers with respect to the date when the first Roth 401(k) contribution was made?

Compliance with reporting requirements (Forms W-2 and 1099-R).

Confirmation that the ERISA anti-alienation protections (creditor protection) would apply to Roth IRA assets rolled over to a Roth 401(k).

Clarification on the application of the required minimum distribution (RMD) at age 70½ rules. Currently Roth IRA's are not subject to the RMD rules, but Roth 401(k) contributions are.

Rules regarding tax implications of distributions within the 5-year aging period.

Ability of an employee to rollover a Roth IRA into a Roth 401(k) plan before becoming a participant.

The interaction between the automatic rollover IRA rules and the Roth IRA rules.

When can the Roth account be offered in our 401(k)?

Plan years starting after January 1, 2006. But, unless Congress passes certain legislation, Roth 401(k)'s will not be allowed past 2011.

How many employers will be adding the Roth to their 401(k) Plan?

According to a survey by Hewitt Associates, the Roth 401(k) may be offered by about 30% of employers as an alternative to a traditional 401(k).

What do we do to add the Roth 401(k) to our plan?

Please contact Trendcepts for the amendment that must be adopted. Once the amendment is adopted, a Summary of Material Modifications, enrollment forms and the Safe Harbor Notice (where applicable) will be modified to match the terms of the amendment.

Please note that the IRS has informally indicated that it "may" draft a sample good-faith amendment. The amendment we would send you is based on language found in the IRS Listing of Required Modifications and, in the opinion of our document provider, would be considered a good-faith amendment. In the event that additional modifications are required, an updated amendment would be provided, if we feel it is likely that employers who have adopted this amendment will need to take further action.