

**EMPLOYER CONSIDERATIONS IN  
DECIDING WHETHER TO OFFER  
ROTH 401(k) ACCOUNTS**

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## What Are Roth 401(k) Accounts?

- In lieu of pre-tax elective deferral can irrevocably make after-tax contribution
- Earnings grow tax exempt
- If contributions have been held for 5 years or more a qualified distribution of contribution and earnings will not be taxable

# Qualified Distribution

- Age 59 ½
- Death
- Disability
- No first-time home

## Comparison to Roth IRAs

- Roth IRA has income limit (\$110K single, \$160K joint)
- Roth 401k has no income limits permit HCEs to take advantage
- Roth IRA contributions limited to \$4,000/yr (\$5,000 < 50 catch-up)
- Roth 401k contributions are limited to \$15,000/yr (\$20,000 < 50 catch-up)

## Comparison to Roth IRAs

- Not subject to required minimum distributions
- IRA distributions have ordering rules (basis first)
- Can convert traditional IRA
- Subject to RMD- begin distributions at age 70 ½
- No ordering rules
- Cannot convert traditional pre-tax elective deferrals

## Coordination of Elective Deferrals

- One 402(g) limit for both traditional 401(k) and Roth 401(k) contributions
  - Currently 15,000 (\$20,000 if Age 50)
  - Ex. Age 51 can defer \$20,000---\$10,000 as traditional 401k and \$10,000 as Roth 401k

## Excess Elective Deferrals

- Can distribute excess by 4/15 of following year
  - Excess not taxable to the extent of Roth contributions
  - Plan can allow participant to designate excess deferral as Roth
  - Plan may provide any excess deferrals under ER plans are/are not Roth
  - Tax free, but Gap income taxable
  - If not distributed by 4/15, then all taxable when distributed

# Qualified Distributions

- Qualified Purpose
- 5-Year Requirement
  - Starts with first contribution (count years)
  - Rollover to another Roth 401k preserves start date
  - Rollover to new Roth IRA re-starts counting
  - Rollover to existing Roth IRA starts from first contribution to that IRA

# Non-Qualified Distributions

- Any distribution not meeting qualified distribution rules
- Taxed under Section 72
  - Proportionate share of distribution that relates to investment gain is taxable

## Non-Qualified Distributions

- Ex. Roth account balance of \$15,000 consisting of \$12,000 in contributions and \$3,000 in gain. A \$5,000 distribution results in  $1/5$  ( $\$3,000/\$15,000$ ) or \$1,000 being taxed.

## Matching Contributions

Roth contributions must be matched like traditional

- But match is to the traditional plan not a Roth contribution

## ADP Test

- ADP = avg of each EEs elective deferral/compensation
- Test = 1.25 test or 2+2 test
  - 1.25 test =  $\text{HCE ADP} \leq \text{NHCE ADP} \times 1.25$
  - 2+2 test =  $\text{HCE ADP} \leq \text{NHCE ADP} + 2$ ; and
  - $\text{HCE ADP} \leq \text{NHCE ADP} \times 2$

## ADP Test

- Roth contributions count as elective deferrals in ADP test
- If fail test can distribute excess w/in 2½ mos. (3/15 ) of close of year
  - Plan can provide HCE can designate distribution comes from Roth first
  - Tax free, but Gap income taxable in yr of contribution
  - If not distributed by 3/15, then taxable income in yr distributed

# Employer Considerations

- Costs
- Utilization
- Plan Design

## ER Considerations- Costs

- One-time set-up costs
  - Amend the plan
  - New SPD/SMM
  - New election forms
  - Payroll system to account for types of contributions
- Ongoing Administration
  - Separate Accounting
    - Need not be a separate physical account
    - Must account for basis, earnings, and 5-year period
  - Participant Education

# Utilization

- If you build it, will they come?
  - Employee Considerations
  - Effect on ADP Test

# Employee Considerations

Do I participate in 401(k) at all?

Roth - Tax Me Now or Tax Me Later

Advantages for the Higher Earners

# Tax Me Now or Tax Me Later

What will tax rate be at retirement?

1. Expect to be higher (or just want to be certain)---Roth
2. Expect to be lower---Traditional

## HCE Advantages: Roth 401(k)

- Higher Paid Not Eligible for Roth-IRA Can Build Up Bigger Account Balance
- Contribute More
- Rollover to Roth-IRA (even if otherwise couldn't have one) for estate planning
- 5-year period of 401(k) does not transfer

## Estate Planning Advantages: Roth IRA

- Roth-IRA is a great tool for transferring wealth to next generation
- Beneficiary of a Roth-IRA does not have IRD at the owner's death
- Because no MRDs, the balance is not depleted if not needed
- Beneficiary must take all w/in 5 years or lifetime distributions
  - Unless spouse who can rollover into own Roth-IRA

## New Roth IRA Conversion

- Last Tax Act-Tax Increase Prevention Act
- Beginning in 2010 anyone can convert an IRA to a Roth IRA
  - Used to be limited to \$100,000 AGI or less
- For 2010 pay tax in 2011 and 2012
- Loop Hole: Appears can roll traditional 401k into IRA and then convert

## Utilization- ADP Test

- After-tax dollars could lower ADP for NHCEs
- Tax advantages could increase ADP of HCEs

# ADP Example-Traditional 401k

ER matches 1:1 up to 5%

1 HCE \$200K defers \$15,000 pre-tax= 7.5 ADP

6 NHCEs:

1. \$30,000 defers 0%

2. \$45,000 defers 0%

3. \$60,000 defers 5% = \$3000 @ 25% tax rate saves \$750 tax

4. \$60,000 defers 7.5% = \$4500 @ 25% tax rate saves \$1125 tax

5. \$70,000 @ 8% = \$5600 @ 25% tax rate saves \$1400 tax

6. \$75,000 @ 20% = \$15,000 @ 28% tax rate saves \$4200 tax

NHCE ADP=6.75 X 1.25 = 8.4, PASSES

## ADP Example-Roth 401k

1 HCE \$200K defers \$15,000 pre-tax= 7.5 ADP

6 NHCEs:

1. \$35,000 @ 0%
2. \$40,000 @ 0%
3. \$60,000 @ 4% = \$2400 + 600 tax = 3000 same net pay
4. \$60,000 @ 6% = \$3600 + 900 tax = 4500 same net pay
5. \$70,000 @ 6% = \$4200 + 1050 tax = \$5250 compared to \$5600
6. \$75,000 @ 15% = \$11250 + 2812 tax = \$14062 compared to \$15000

NHCE ADP = 5.2 X 1.25 = 6.5 Fails

5.2 + 2 = 7.2 Fails

## Utilization

- Educate employees as to how Roth's work
  - Advantages and disadvantages
- Take a straw poll
- SNSFE can help
  - Prepare a survey customized to your plan
  - Designed to educate and obtain data for analysis

## Plan Design-General

- Good time to review overall plan design
- Is the plan meeting the goals of the employer?
  - Are HCEs happy?
  - Are NHCEs participating?
- Is there a better plan design to accomplish goals?
  - Safe harbor plan
  - Cross-tested

## Plan Design-Roth 401k

- Excess elective deferrals and ADP
- Automatic Enrollment
  - Plan may provide that default is Roth contribution absent affirmative election from EE
- Loans
  - Prop Regs. Roth account counts toward available loan amount
  - Default causes Roth portion to be taxable regardless of 5-year rule
  - Plan can restrict loans from Roth account to ease administration

# Plan Design-Open Issues

- Hardship Distributions
  - Prop Regs. Roth deferrals count in determining what's available (not earnings)
  - No ordering rules
    - Can EE choose?
- QDROs-Can spouse designate Roth to pay?
- How long will it last?
  - Will sunset in 2010 unless amended

## Conclusion

- Roth 401k can be great benefit under right circumstances
- Employer goals should drive decision whether to offer
- Now is the time to consider
- Consult competent professional

SCOTT GALBREATH focuses his practice on employee benefits and executive compensation. He was recently recognized as an Illinois Leading Lawyer in the category of employee benefits.

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