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**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

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Qualified Distribution

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

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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 = $HCE\ ADP \leq NHCE\ ADP \times 1.25$
 - 2+2 test = $HCE\ ADP \leq NHCE\ ADP + 2$; and
 - $HCE\ ADP \leq NHCE\ ADP \times 2$

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 NHCs 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.

His experience includes the design and formation of qualified employee benefit plans, nonqualified deferred compensation programs, and welfare benefit plans; plan administration, plan correction, fiduciary duty counseling to plan fiduciaries, and plan transactions and terminations.

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