



## ADVISOR ALERT

### The Roth 401(k) - To be or not to be...

On or after January 1, 2006, qualified retirement plans will be able to offer the ability for participants to contribute some or all their 401(k) money into a Roth 401(k) account. Roth K accounts are different from the traditional 401(k) in several basic respects.

- Roth K contributions are made with after tax money where regular K contributions are made with pre-tax money;
- Roth K accounts pay out tax free so long as the withdrawal occurs at least 5 years after the first deferral is made and attainment of age 59½ where regular K accounts are totally subject to ordinary income taxation;
- Roth K accounts which are rolled over to a Roth IRA are not subject to those pesky minimum distribution rules (age 70½ or at retirement) the regular K accounts must follow;

The above goodies may be tempered a bit by administrative fine print. As of this writing, IRS has not yet issued the language necessary to authorize use of the Roth K accounts and it is vague on the release timing. The law authorizing the Roth K is scheduled to self destruct in 2010, so we might ramp up to accommodate the feature only to find it short lived. Employee contribution limits (\$15,000 plus \$5,000 makeup in 2006) apply equally to Roth and regular K accounts.

Discrimination testing applies to both the Roth and regular K. The regular distribution rules apply equally to each K type. Most advisors are in agreement that the following plan and payroll related costs will increase to deal with the complexities of the Roth K account.

- Plan documents and employee booklets will need to be amended to create the accounts;

- ⊖ This option will increase payroll and recordkeeping efforts;
- ⊖ Roth K accounts will need to have their cost basis separately tracked;
- ⊖ Plan mandatory distribution processes will need to include BOTH a Roth and regular IRA;
- ⊖ If the plan fails the ADP discrimination test, Roth rules permit the participant to direct which account to tap for corrective distributions. This will add time and complexity to plan testing completion;
- ⊖ Failure to distribute excess deferrals by the deadline will cause double taxation - first when the amounts were contributed and second when the excesses are actually distributed;
- ⊖ The 70½ rule still applies to Roth K money not rolled into a Roth IRA. Such distributions will require a document amendment to allow for in-service distribution;
- ⊖ The five year tracking of contributions could get very tricky and making a mistake will lead to taxation on the account gains and a potential 10% excise tax as well;
- ⊖ Defaulted loans from a Roth account may be subject to excise taxes.

While the Roth K may be attractive to participants wishing to hedge against future taxation, given the current lack of IRS language and that the participant establishment of a Roth K account is an irrevocable designation, some advisors do not recommend beginning a Roth K program until IRS issues model language and the plan sponsor has a firm grasp of the extra complexities and costs which will impact on the Roth K addition. Others suggest that the amendment need not be adopted until the last day of the plan year following January 1, 2006. The Roth K program may be launched anytime after January 1, 2006.

So far, most of the Roth K enthusiasm has been driven by funding providers. Eventually, that interest will trickle down to plan sponsors and employees who will likely have questions about their options. In that regard, your questions and concerns are always welcome.