Roth 401(k) Plans

Many plans have added a Roth 401(k) feature because of employee requests

A Roth deferral plan is part of a traditional 401(k) plan. Deferring into the Roth portion of the 401(k) plan allows the participants to contribute after-tax dollars to the plan. By deferring after tax dollars, the participant will avoid taxation on the account when the money is distributed. In contrast, a regular 401(k) deferral is on a pre-tax basis and the contribution and earnings are subject to taxes when the money is withdrawn.

A Roth 401(k) can be advantageous because the constructs of the Roth 401(k) are similar to the Roth IRA. The IRS phases out the contributions to a Roth IRA based on the individual's adjusted gross income. However, there are no such income constraints for contributions to a Roth 401(k).

Many employers have made the move to add a Roth 401(k) feature to their existing 401(k) plans. Some sponsors have done so based on the recommendations of their investment advisor, while many others have implemented the new feature based on the requests of the plan participants. Is the Roth 401(k) feature right for your plan?

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PLAN SPONSOR SERIES
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Should your plan add a Roth 401(k)?

In a traditional 401(k), participants invest money into a 401(k) plan on a pre-tax basis. This means they pay no taxes on the money that is invested into the 401(k) plan today, but they will be taxed on any withdrawals they make from the 401(k) plan in the future. In a Roth 401(k) plan, after tax dollars are invested in the plan, but at the time of a ***"qualified"*** withdrawal, there will be no tax on their amount invested or the associated earnings. If the tax brackets are the same at the time of the deferral and the time of the withdrawal, the taxation between a traditional 401(k) and Roth 401(k) will be the same. If you expect your taxable rate to be higher when you are workings and lower when you will be withdrawing your money for retirement, then a traditional 401(k) plan is the right choice for you. If you believe your tax bracket will be lower in your working years and higher in your retirement years, then the Roth 401(k) is the way to go for you. As the future tax rate is impossible to predict, the choice is a very personal one as shown below.

Investment of $10,000 over 20 years with a 6% return

	Tax Bracket		After Tax Account at Retirement	
	Current	Retirement	Traditional 401(k)	Roth 401(k)
Taxes same at retirement	27%	27%	**$367,856**	**$367,856**
Taxes higher at retirement	27%	33%	$337,621	**$367,856**
Taxes lower at retirement	27%	23%	**$388,012**	$367,856

Roth contributions are subject to different rules than standard 401(k) withdrawals. To avoid taxation on the earnings portion of the Roth contribution, the distribution must be ***"qualified."*** In order to be qualified, contributions to the Roth account must have commenced at least 5 years prior to the withdrawal. The withdrawal must also be made due to retirement, death, disability or the attainment of age 59 1/2 to be considered qualified. Roth contributions can also escape the Required Minimum Distribution rules if the Roth 401(k) is rolled over to a Roth IRA prior to the required minimum distribution age of 70 1/2.

The extra costs associated with implementing a Roth 401(k) have to do with the plan set up and eventual distribution of the funds. To add a Roth 401(k) feature to your plan, there must be a plan amendment, changes to the existing administration forms, employee education and changes to your payroll systems. New Summary Plan Descriptions must be prepared and distributed to the plan participants. Distributions are more complex because of the requirement to track the income separately from the contributions for Roth accounts. But overall, adding a Roth 401(k) feature is very affordable.

Roth 401(k) features can be advantageous for owners and participants alike. Call today if you are interested!