DailyAccess Roth 401(k) Contributions Start in 2006

Proposed IRS regulations issued on March 2, 2005, with an effective date of January 1, 2006, will allow participants in traditional 401(k) plans to designate all or part of their employee deferrals as Roth 401(k) contributions. Employers who sponsor 401(k) plans may elect (but are not required) to offer the Roth 401(k) option to participants in their plans.

The proposed regulations also allow participants in 403(b) plans to make Roth 403(b) contributions to their traditional 403(b) plans under similar rules.

Definition of Roth 401(k) Contribution:

Roth 401(k) contributions are **after-tax** employee deferral contributions made to a traditional 401(k) plan. The Roth 401(k) contributions and earnings will be maintained in a separate account referred to as a Roth 401(k) account. The contributions are subject to current taxation, but qualified distributions from the Roth 401(k) account (including earnings) are tax-free. In other words, there is no tax deduction for the contribution, but amounts distributed from the Roth 401(k) account will generally not be subject to further taxation.

DailyAccess Corporation will be ready to support the Roth 401(k) option starting January 1, 2006. Employers will have work to do between now and January 1st including (1) notifying DailyAccess of their decision to offer the Roth 401(k) option; (2) verifying their payroll provider can support a Roth 401(k) option and (3) obtaining Roth 401(k) deferral elections from plan participants.

Factors to Consider Before Electing a Roth 401(k) Option:

The ***primary advantage*** of a Roth 401(k) option is that it results in ***tax-free earnings*** on the contributions made to the account. A participant pays taxes on the contributions going into the account, but all funds (contributions and earnings) come out of the account on a tax-free basis. In a regular 401(k) account the earnings are only tax-deferred, and the taxes on the contributions and earnings are due when the funds are distributed.

The ***primary disadvantage*** of a Roth 401(k) option is that contributions are made on an ***after-tax*** basis. A participant does not receive a tax deduction for the Roth 401(k) contributions and does not get the advantage of reduced taxable income and reduced taxes in the year of contribution. The net effect is that a participant must use more income to fund a contribution to a Roth 401(k) account. For example, assuming a 20% tax rate, a $10,000 regular 401(k) contribution requires $12,500 in income to fund the same $10,000 contribution to a Roth 401(k) account ($2,500 in taxes and $10,000 in contribution).

The Roth 401(k) option is not a cure for correcting test failures and increasing deferral limits. In fact, the Roth 401(k) option provides no significant benefit to either the 401(k) plan or the plan sponsor. Roth 401(k) contributions are **not** treated like catchup contributions: they do not increase a participant's deferral limit, help ADP nondiscrimination testing results, or eliminate the need for test failure refunds. For most plan purposes, Roth 401(k) contributions are treated like a regular deferral.

Who benefits from a Roth 401(k)?

The Roth approach will work for some participants, but not for everyone. DailyAccess did the number crunching and discovered that the Roth approach will benefit participants who....

- Expect to be paying a higher tax rate at retirement. The participant will make "after-tax" Roth 401(k) contributions to the plan, pay taxes now when tax rates are lower and avoid paying the higher tax rate at retirement. In this scenario, the tax-free distribution at retirement is more valuable to the participant than the tax deduction available when the contribution is funded to the plan.
- Can afford to defer the same amount under the Roth approach as they could using regular pre-tax deferrals. If a participant can afford to fund a Roth deferral equal to the amount he or she would contribute as a regular deferral and pay the taxes on the Roth deferral, the Roth option will generally result in a larger nest egg at retirement.
- Intend to pass the retirement funds on to their heirs. If a participant will not need the retirement funds during his or her lifetime, the Roth approach will generally result in a larger inheritance at the participant's death.

The regular 401(k) approach will benefit participants who...

- Expect to be paying a lower tax rate at retirement. In this case, the tax deduction on contributions is more valuable than tax-free distributions at retirement. The participant will avoid the higher current tax rate by making pre-tax "regular" deferral contributions and pay taxes on benefits received at retirement when the tax rate is lower.
- Cannot afford to defer as much under the Roth approach. Participants who are on a limited budget will be able to defer more into the plan under the regular 401(k) approach and will generally accumulate larger nest eggs for retirement.
- Will receive a smaller matching contribution under the Roth option. If a participant cannot defer as much in Roth deferrals as he or she could in regular 401(k) deferrals, the participant may get a smaller matching contribution. Less money going into one's retirement account will generally result in a smaller nest egg for retirement.

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Making a decision on the Roth approach will not be an easy one for many participants. There are numerous factors a participant needs to consider in electing to make a Roth 401(k) contribution. The factors to consider and the proper decision will be different for each participant. DailyAccess can help with this process. Our Consulting Department is available to run detailed analysis for your participants. Please contact your DailyAccess Account Executive for more details.

Deferral Election for Roth 401(k) Contributions:

Participants can elect the percentage of their elective deferrals that will be considered a Roth 401(k) contribution. The election can range from 0% to 100%. For example, a participant may elect to have 50% of his or her deferral treated as a regular 401(k) contribution and the other 50% treated as a Roth 401(k) contribution. Alternatively, a participant may elect to have 3% of his or her compensation deferred into the plan as a regular contribution and 2% of his compensation deferred into the plan as a Roth 401(k) contribution. The only catch is that the participant must make an irrevocable election to treat a deferral contribution as a regular or Roth contribution **before** the contribution is actually deposited to the plan.

Limits on Roth 401(k) Contributions:

The combination of regular 401(k) contributions and Roth 401(k) contributions cannot exceed $15,000 for 2006. Employees who are age 50 or older can also make an additional $5,000 catchup contribution. Additionally, participants who make Roth 401(k) contributions may still make contributions to a Roth IRA (if they meet the income requirements for a Roth IRA contribution). There are no income limits restricting a participant's ability to make a Roth 401(k) deferral contribution.

Matching Contributions:

All matching contributions, including those made on Roth 401(k) contributions, are pre-tax contributions. Matching contributions made on Roth 401(k) contributions, and related earnings, are taxable when distributed.

Nondiscrimination Testing:

Roth 401(k) contributions are combined with regular 401(k) deferrals for ADP nondiscrimination testing and are treated like regular 401(k) contributions for other testing purposes. A plan may allow participants to elect the order of corrective test failure refunds (regular vs. Roth). Additionally, the Roth 401(k) option must be made available to participants on a nondiscriminatory basis.

Distribution Requirements:

Roth 401(k) deferral contributions are subject to the same distribution requirements as regular 401(k) deferral contributions. Consequently, a plan **may permit** a participant to receive a distribution of his or her Roth 401(k) account for any of the following reasons: termination of employment, attainment of age 59 1/2, death, disability, plan termination or financial hardship (contributions only, no earnings).

However, Roth 401(k) accounts are subject to the distribution requirements of the underlying 401(k) plan. For example, if the underlying plan does not allow financial hardship distributions, the Roth 401(k) account will not be available for financial hardship distributions.

Additionally, Roth 401(k) accounts are subject to the age 70 1/2 minimum required distribution requirements and the mandatory cashout/automatic rollover rules.

A Roth 401(k) account can only be rolled over to a Roth IRA or another plan that accepts Roth 401(k) contributions. As a result, participants may need to arrange for two IRA accounts (one for pre-tax funds and one for Roth account) and request two distributions from the plan (one to the regular IRA and one to the Roth IRA). Participants who use the Roth approach should expect to pay more fees for distribution processing and IRA maintenance.

"Qualified Distribution" Requirements:

If a participant wants his or her distribution to be tax-free, it must be a "qualified distribution." In order to be a qualified distribution, two basic requirements must be satisfied:

- Acceptable Reason - The distribution must be due to the participant's **attainment of age 59 1/2, death or disability**. These are the only three acceptable distribution reasons for a qualified distribution.

- 5 Year Period - The distribution must be paid no sooner than five years **after** the first calendar year a participant makes a Roth 401(k) contribution to the plan or a predecessor Roth 401(k) plan. Due to this 5 year rule, January 1, 2011 is the earliest a qualified distribution can be paid from a 401(k) plan.

Distributions (including financial hardship and in-service distributions) that do not satisfy these requirements will be subject to taxation and, if applicable, the 10% premature distribution penalty on the **earnings portion of the distribution only**. However, a participant who receives a "non-qualified distribution" can recoup qualified status by rolling over to a Roth IRA or another Roth 401(k) plan and taking a "qualified distribution" when both requirements have been satisfied.

Plan Amendment to Add the Roth 401(k) Option:

Unless further guidance is issued by the IRS, plans that offer the Roth 401(k) option for the 2006 plan year will need to be amended by the last day of the 2006 plan year to add Roth 401(k) language to their plan document. This means that a calendar year plan will need to be amended by December 31, 2006. However, be aware this also means that a plan with a plan year-end of January 31st will need to be amended by January 31, 2006 (if the Roth 401(k) option is offered prior to January 31, 2006).

Participants will need to be provided an updated Summary Plan Description (SPD) or Summary of Material Modifications (SMM) that explains the Roth 401(k) amendment.

The IRS has not yet issued a sample amendment or sample SPD/SMM language for this purpose. DailyAccess will not start the amendment process for our clients until the IRS issues acceptable amendment language.

Sunset Provision:

The Roth 401(k) option was added to the Internal Revenue Code with an effective date of January 1, 2006 and an automatic sunset after 2010. This means that, unless Congress takes steps to extend or eliminate the sunset, the Roth 401(k) option will be discontinued after 2010.

Outstanding Issues:

There are some outstanding issues that the IRS has not yet issued guidance for...

- Will **separate tax reporting** (Form 1099-R) be required for Roth vs. regular funds?
- Will **separate distributions** be required for Roth (tax-free) vs. regular (taxable) distributions?
- Who will be responsible for **tracking of the 5 year period** for a qualified distribution?
- Can a participant elect whether a **partial distribution** consists of only tax-free dollars?

Additional Considerations for the Employer:

Employers who desire to offer the Roth 401(k) option in their existing 401(k) plan should be aware of the following additional issues...

- Written Instructions - Employers will need to provide DailyAccess with written instructions to install the Roth 401(k) option in their 401(k) plan.

- Communicate with Participants - The Roth 401(k) option will be a new concept for many plan participants. Participants will need to be provided clear explanations of the Roth 401(k) option so they can make an informed choice and to limit the employer's liability from future claims of improper direction into a Roth or non-Roth option.

- New Employee Deferral Elections - Employers will need to obtain new enrollment forms from plan participants specifying the amount of Roth and regular 401(k) deferrals to be withheld from their pay. DailyAccess will be providing updated enrollment forms for this purpose in the near future.

- Payroll Provider - Employers must withhold income taxes from Roth 401(k) contributons and report both the contributions and taxes on a participant's Form W-2. Employers should contact their payroll providers to discuss the provider's capabilities and establish the process for withholding both regular pre-tax deferrals and Roth post-tax deferrals from employees' paychecks.

- Payroll Uploads to DailyAccess - Employers will need to provide a breakdown of regular 401(k) deferrals and Roth 401(k) deferrals on their payroll uploads to DailyAccess. Each deferral type should be listed in a separate column on the payroll upload. DailyAccess will provide a payroll template to employers for this purpose.

The Roth 401(k) contribution will be an intriguing option for many employers and participants. Although not available until January 1, 2006, there are many considerations and decisions that must be made between now and January 1st. DailyAccess will be prepared to support your Roth 401(k) contributions on January 1st and is ready now to help you through this important decision making process.

Please contact your DailyAccess Account Executive at 888-535-4322 with any questions you may have about the Roth 401(k) option.