

# Benefit Insights



## **POLLARD & ASSOCIATES, INC.**

*Consultants, Actuaries & Administrators of Pension & Profit Sharing Plans Since 1970*

One North Park Drive  
Suite 104  
Hunt Valley, MD 21030  
410.252.5200  
www.pollardpensions.com

A non-technical review of qualified retirement plan legislative and administrative issues

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## Roth 401(k) FAQs

Designated Roth contributions (a/k/a Roth 401(k) or Roth deferrals) have been available since 2006, but a change in the tax laws governing Roth IRAs has reenergized discussions about this feature. This article is in Q&A format and addresses some of the more common questions about Roth 401(k) contributions. But first, a brief overview...

Traditional deferrals reduce a participant's income for federal and, in most cases, state tax purposes at the time of contribution. Those amounts grow on a tax-deferred basis until the participant takes a distribution, which is taxable as ordinary income. Roth deferrals are fully taxable to the participant at the time of contribution. However, if certain requirements are met, so-called "qualified distributions" of Roth deferrals and the earnings thereon are completely tax free.

Apart from the tax differences, Roth deferrals are treated the same as traditional deferrals for all plan purposes. The normal limits and non-discrimination requirements apply. Roth deferrals are also subject to the same withdrawal

restrictions, i.e. death, disability, retirement, financial hardship, etc.

### **What types of plans can allow Roth deferrals?**

Both 401(k) and 403(b) plans can include a Roth component.

### **Are there any income restrictions preventing higher wage earners from making Roth 401(k) contributions?**

No. Unlike Roth IRAs, any employee eligible for the plan can make Roth deferrals regardless of income.

### **What are the limits on the amount of Roth deferrals a participant can contribute?**

The salary deferral limit is \$16,500 for 2010. Roth and pre-tax deferrals are added together for purposes of this limit.

### **Can catch-up contributions be designated as Roth deferrals?**

Yes. Catch-up contributions merely represent an increase in the regular deferral limit for those who are catch-up eligible.

### **What is all the buzz about Roth conversions in 2010?**

Prior to 2010, those above a certain income threshold (generally \$120,000 for individuals and \$176,000 for married couples) were not permitted to make Roth IRA contributions. Starting this year, that income cap is removed for those who wish to convert non-Roth IRAs into Roth IRA accounts. The amounts converted must be included in taxable income; however, those who convert during 2010 have the option to spread that tax liability equally over two years.

### **Can a participant elect to convert pre-tax 401(k) deferrals into Roth 401(k) deferrals?**

No. The regulations make it very clear that when a participant elects to make pre-tax deferrals, that election is irrevocable. While the participant may change how future contributions are designated, existing contributions cannot be converted within the plan. However, there has been discussion on Capitol Hill about changing the law to allow conversions inside the 401(k) plan similar to the IRA conversions that are allowed beginning in 2010.

### **Can Roth 401(k) accounts be directly rolled over into another 401(k) plan or a Roth IRA?**

Yes. Roth accounts from a qualified plan or 403(b) plan can be rolled into another qualified plan or 403(b) plan that allows Roth contributions. These amounts can also be rolled into a Roth IRA.

### **Can a Roth IRA be rolled over into a Roth 401(k) or 403(b)?**

No. Roth IRAs can only be rolled into other Roth IRAs.

### **What are the requirements that must be satisfied to receive a tax-free distribution from a Roth account?**

A participant must complete a so-called five-year period and the distribution must occur on or after attainment of age 59½, death or disability. A tax-free Roth distribution is referred to as a qualified distribution.

### **What is the five-year period and when does it start?**

The five-year period is generally a holding period a participant must satisfy to take a qualified distribution. It begins on the first day of the first taxable year in which a participant first makes Roth deferrals to the plan. For example, if a participant makes his first Roth deferral on October 1, 2010, the five-year period starts on January 1, 2010.

### **Is the plan sponsor or the participant responsible for tracking the five-year period?**

Plan sponsors and their service providers are required to track the Roth five-year period as well as the amount of basis for each participant. This requirement is likely to present significant record-keeping challenges, especially in takeover situations.

### **Does the five-year period start over when a participant goes to work for another company and makes Roth deferrals into his new employer's plan?**

It depends. If the participant rolls over his Roth account to the new plan, the portion of the five-year period already satisfied is transferred to the new plan. However, if the participant does not roll over the Roth account, his five-year period starts over with respect to contributions to the new plan.

### **Is there any coordination between the Roth 401(k) and Roth IRA five-year periods?**

No. The two five-year periods are determined independently of one another. Thus, a rollover of a Roth deferral account into a Roth IRA requires the five-year period to be redetermined.

### **What happens if a participant takes a loan from the Roth account and then defaults, requiring deemed distribution of the outstanding balance?**

A deemed distribution of a participant loan is never treated as a qualified distribution even if it occurs after the participant has satisfied the five-year period and attained age 59½, died or become disabled. Therefore, the portion of the deemed distribution attributable to Roth is subject to income tax. To avoid confusion in this area, the loan policy can be written to restrict participant loans to non-Roth accounts.

### **Do Roth deferrals affect ADP testing?**

Yes. Roth deferrals are included with pre-tax deferrals for purposes of the ADP test. However, since Roth deferrals are not tax-deductible, lower-paid participants may be unable to defer at the same level as with pre-tax deferrals.

Example: Marge earns \$50,000 and has \$5,000 available to save for retirement. She is in a combined 25% tax bracket. If Marge makes pre-tax deferrals, she can contribute the full \$5,000 to the plan. However, if Marge makes Roth deferrals, she must pay \$1,250 (25% of \$5,000) in taxes, leaving her with only \$3,750 to contribute to the plan. Since Marge is a non-highly compensated employee, her lower deferral percentage would have a negative impact on the ADP test.

Annual Salary: \$50,000  
Total Available for Savings: \$5,000

	<u>Pre-Tax</u>	<u>Roth</u>
Income Tax (25%)	0	\$1,250
401(k) Deferral	\$5,000	\$3,750
Deferral Percent	10%	7.50%

Employers may want to consider a safe-harbor 401(k) plan if they are likely to experience this situation.

### **Can availability of Roth deferrals be restricted to those whose incomes are high enough to maximize their contributions?**

No. The availability of Roth deferrals is subject to the minimum coverage rules for 401(k) plans and the universal availability rules for 403(b) plans.

### **Are Roth deferrals considered when calculating the employer matching contribution?**

Unless plan terms specify otherwise, pre-tax and Roth deferrals are both considered in the employer match calculation. Matching contributions are always treated as tax-deferred regardless of whether Roth deferrals are used in the calculation.

### **Are Roth deferrals subject to Required Minimum Distributions?**

Yes. The regulations specifically provide that Roth deferrals are subject to the required minimum distribution rules. This is in contrast to Roth IRAs which do not require minimum distributions. It appears that a participant may avoid required minimum distributions on Roth deferrals by rolling over these amounts to a Roth IRA prior to the attainment of age 70½.

### **Do the automatic IRA rollover rules apply to Roth deferrals?**

No. Roth and pre-tax accounts are considered separately for purposes of the automatic rollover rules. Therefore, to the extent the Roth and/or pre-tax portion of a participant's account is less than \$1,000, it is not required to be automatically rolled over even though the combined vested account balance may exceed \$1,000.

### **Can a plan that does not otherwise allow Roth contributions accept a Roth rollover?**

No. Regulations clearly state that a designated Roth account can only be rolled over into another 401(k) or 403(b) plan that has a designated Roth program.

### **Is the employer required to report any information at the time Roth deferrals are contributed to the plan?**

Yes. Employers must report Roth deferrals in box 12 of Form W-2 with code AA for 401(k) plans and BB for 403(b) plans.

## **How are Roth distributions reported on Form 1099-R?**

Roth distributions must be reported on a separate Form 1099-R using Code B. The non-taxable basis is reported in Box 5, and the beginning of the five-year period is reported in an unnumbered box next to Box 10.

## **Are there any reporting requirements for a participant who elects Roth deferrals?**

No. The participant is not required to report any additional information with respect to Roth 401(k) or 403(b) contributions. However, a participant rolling over a Roth deferral account into a Roth IRA must keep track of the rollover amounts and the five-year period with respect to the IRA.

## **Which is better for participants – Roth or pre-tax deferrals?**

The answer to this question depends on each individual's financial situation and is beyond the scope of this article. Factors such as current and

future tax brackets, estate planning needs and more will impact the decision, so participants should consult their tax and/or legal advisors for assistance in reviewing all of the relevant facts and circumstances.

## **Conclusion**

While Roth IRAs are enjoying significant publicity due to the change in the conversion rules, it is interesting to note that there has not been significant implementation of the feature in 401(k) plans. According to the Profit Sharing/401(k) Council of America's 52<sup>nd</sup> Annual Survey, 36.7% of plans allowed Roth contributions in 2008; however, only 15.6% of participants that had the Roth option available elected to take advantage of it.

Plan sponsors who are considering Roth 401(k) deferrals should consult with their advisors and service providers to review the potential advantages and disadvantages that the Roth feature provides.

This newsletter is intended to provide general information on matters of interest in the area of qualified retirement plans and is distributed with the understanding that the publisher and distributor are not rendering legal, tax or other professional advice. You should not act or rely on any information in this newsletter without first seeking the advice of a qualified tax advisor such as an attorney or CPA.

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*One North Park Drive • Suite 104 • Hunt Valley, Maryland 21030*

*Telephone: 410.252.5200 • Fax: 410.771.3035 • Toll Free 800.933.1776 • Email: [info@pollardpension.com](mailto:info@pollardpension.com)*