



Information Release

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New in 2006: Roth 401(k) Plans

Beginning in 2006, 401(k) plans will be allowed to permit employees to designate some (or all) of their elective contributions as Roth 401(k) contributions.

What is a Roth 401(k) contribution?

Traditional 401(k) contributions are **excluded** from an employee's taxable income in the year they are made but the account balance, including earnings, is taxed as ordinary income when it is distributed.

On the other hand, Roth 401(k) contributions are **not** excluded from an employee's taxable income when they are made. However, distributions of these contributions, along with their investment income are **tax free**.

Which is better?

Which is better? It depends. Age, yield on investments, present and future tax rates are all factors that must be considered. We have created a Roth 401(k) calculator, which is available on our website at www.lkravitz.com/roth. This calculator will allow you to compare the after-tax amounts that will be available at retirement under both types of 401(k)s, using assumptions that you choose.

How does a Roth 401(k) differ from a Roth IRA?

There is no income threshold for a Roth 401(k)—all participants can contribute regardless of how much money they make. An individual can contribute to a Roth IRA only if his or her income does not exceed a threshold amount.

An individual can contribute up to \$4,000 to a Roth IRA in 2005 (subject to the income threshold rules). This amount will increase to \$5,000 in 2008 and will be adjusted for cost-of-living increases thereafter. If the individual is age 50 or older in 2005, he or she can make an additional \$500 "catch up" contribution. This amount will increase to \$1,000 in 2006.

In a Roth 401(k), the contribution limits are significantly higher: up to \$15,000 in 2006 plus an additional \$5,000 for those age 50 or older. These amounts will be adjusted for cost-of-living increases beginning in 2007.

What must a plan sponsor do if they want to offer Roth 401(k)s?

Plan documents need to be amended to allow for Roth 401(k) contributions. Presumably, these amendments will need to be adopted prior to any Roth 401(k) contributions being made.

Employees must designate a portion of their 401(k) contributions as Roth 401(k) contributions. Plans will need to have election forms available for participants to do this. Payroll systems must also be able to handle the Roth 401(k) contributions.

Roth 401(k) contributions must be accounted for separately from pre-tax 401(k) contributions. The plan's record keeper must be prepared to track these separate accounts.

What other requirements will a plan have to meet?

Roth 401(k) contributions must be combined with pre-tax 401(k) contributions for purposes of the actual deferral percentage (ADP) test.

The combined Roth 401(k) and pre-tax 401(k) contributions for any individual cannot exceed the annual maximum (\$15,000 in 2006 plus an additional \$5,000 catch up contribution for individuals age 50 and older.)

All contributions must be nonforfeitable.

Accounts are subject to the same distribution restrictions as pre-tax 401(k) accounts. Distributions can only be made upon termination of employment or in cases of financial hardship.

Required minimum distributions must be made to individuals age 70½ and older (or, in the case of a non-5% owner, at termination of employment, if later.)

The plan must provide that Roth 401(k) contributions may be rolled over only to another plan that allows Roth 401(k) contributions or to a Roth IRA.

Employers will be able to make matching contributions with respect to both Roth and traditional 401(k) contributions. Matching contributions are treated the same as under current law regardless of whether they are based on Roth or traditional 401(k) contributions.

What should I do now?

To learn about the advantages of Roth 401(k)s, try out our Roth 401(k) calculator at www.lkravitz.com/roth. To learn more about adding the Roth 401(k) option to your plan, contact your Kravitz consultant, who will be monitoring the latest developments in this area.

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