NAGDCA NOTES

The Roth 401(k): How Can It Benefit Your Participants?

On January 1, 2006, employers were given the option to offer Roth 401(k)s to their employees based upon the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). For many, the Roth 401(k) combines elements of the traditional 401(k) with the tax benefits of the Roth IRA. It allows people to contribute to tax-deferred savings accounts with after-tax dollars in exchange for the benefit of withdrawing that money tax-free in retirement.

In a conventional 401(k) retirement account, a worker contributes some of his/her salary into a tax-deferred retirement account. Any money that is contributed is not subject to income tax when it is put into the account. Instead, the income taxes become due when money is withdrawn from the account. If the Roth 401(k) is offered and participants elect to contribute to the Roth, the amount of the worker's salary that is contributed to the Roth 401(k) is considered as taxable wages in the year in which it is contributed to the Roth 401(k). Once in the account, however, the money grows tax-free and can be withdrawn later without incurring further income tax.

Who benefits from the Roth 401(k)?

Younger workers who will not be retiring for a long time might choose the advantages of tax-free income in the future over the benefits of deferring present income taxes. Lower-income workers also might find the benefits of future tax-free income to be worth more to them than the present tax deferral. They might anticipate that when they withdraw the money, they will be in a higher tax bracket. Workers who are not eligible for a regular Roth IRA because their adjusted gross income is too high might find that the Roth 401(k) gives them a tax-free retirement option. Finally, baby boomers who are looking at ever-increasing federal deficits might wish to opt for the Roth 401(k) as a hedge against what they might think are future income tax rate increases. And those who still cannot make up their minds can choose to do both: set up a regular 401(k) and a Roth 401(k), and split their contributions. Just remember that the total contributions to all 401(k) accounts may not exceed the statutory limits.

Who does not benefit from the Roth 401(k)?

The decision regarding which plan to choose will depend largely on one's personal financial situation. One should assess the current tax rate versus what it is expected to be in the future. If the tax rate now is lower than what it is expected to be in the future, it may be beneficial to consider using after-tax plans (Roth 401(k)). On the other hand, if the expected tax rate is likely to be lower in retirement, tax-deferred programs may be a better option.

Those who may benefit by using a regular 401(k) include low-income workers, who pay no federal tax because they qualify for earned income and additional child tax credits. Many financial experts have suggested that the Roth 401(k) won't be appropriate for those who retire into a lower tax bracket. Of course, many people expect a less-punitive tax bite after they quit work, but this can actually be a dangerous assumption. For example, it is very possible that as individuals continue to work, they increase the potential for promotions. This could occur several times throughout an employee's tenure. With promotions, usually come raises in salary, which has the potential to place individuals into a higher tax bracket when they finally retire.

Time Limitation

One thing that had to be considered when evaluating the Roth 401(k) was its slated expiration date of December 31, 2010. Until the recent Pension Protection Act (PPA), the Roth 401(k) was not to be effective beyond December 31, 2010. The Federal estate tax is another example of this type of expiration date. However, this is not the case with the passing of PPA Sec. 811. Many plans that instated the Roth 401(k) went into the agreement with the knowledge that there was a potential expiration date where administrative costs and accounting would have still been required to facilitate the funds in these accounts. One thought was that if the Roth 401(k) offered, and if participants could fulfill the contribution requirements, some individuals could have opted to rollover their account into a Roth IRA.

What are State and Local Plans, who have implemented the Roth 401(k), saying?*

Kentucky

"Our view that the Roth 401(k) provisions are a significant system enhancement has not changed since its implementation. Participation in the program is steadily increasing as employee awareness grows. Employee education is a very important ingredient for the success of any new program, and has proven especially valuable for the Roth 401(k). Having clear and understandable communications has proven to be quite valuable to our marketing of the Roth 401(k) option."

New York City

"In order to implement the Roth 401(k), the plan first needed to amend its existing 401(k) plan document. The Plan then worked with its payroll departments and the record keeper to make the necessary system changes to allow for after-tax contributions. Identifying all employee communications that needed to be modified to include Roth 401(k) information was done next. The Plan's website, investment planning video, brochures and forms were all updated as a result. To help communicate this new feature of the 401(k) plan, the Plan expanded its internet-based software tool called Personalized Financial Snapshot (PFS) to include a module called 'Understanding the Roth 401(k).' The software first illustrates the differences between investing with before-tax dollars versus after-tax dollars, then gives a comparison summary and concludes with a discussion on tax treatment.

As of October 30, 2006, the City's plan had over 127,000 participants and $7.5 billion in total assets. Contribution to the Roth started in April 2006, and as of October 30, 2006, 11% of all accounts in the 401(k) plan were Roth accounts."

North Carolina

"In anticipation of the Roth feature rollout in June of this year (2006), our provider educated their staff on the new feature, conducted Roth educational webcasts for employers and developed new informational materials. Overall, the transition to offering Roth contributions has been a smooth process. The new Roth feature has been well received by our members across the state. As of October, 1,534 people had elected to make Roth contributions totaling $183,985 for the month, showing that our members recognize the benefits of being able to contribute after-tax dollars today and withdraw that money tax-free at retirement. This is just one of many creative solutions North Carolina has implemented to public employees build a secure retirement."

Tennessee

"The timing to implement designated Roth 401(k) salary deferral election is at the discretion of each of the major payroll centers, University of Tennessee, Tennessee Board of Regents (TBR) and State Employee payroll. It is expected that the designated Roth 401(k) salary deferral election will be offered to all UT employees or will not be offered at all. Likewise it will be offered to all TBR employees or none; and all State payroll employees or none. Our record keeper reports that in October 2006 our first Roth marketing availability month, we had 3 Roth participants by Nov 15, 2006 we had 48 participants. We expect it to pick up with subsequent payrolls."

Estimated designated Roth 401(k) election availability for Tennessee Employees		
Pay Roll Center	**Approximate Time Frame**	**Year**
UT Employees	October	2006
TBR Employees	Winter	2007
State Employees		2008

Whitehouse, Kaja, "Roth 401(k) Requires Tax Forecasting", Post-gazzett.com, http://www.post-gazette.com/pg/pp/05246/562148.stm

Vanguard Center for Retirement Research, "Tax Diversification and the Roth 401(k); http://www.pcarbi.org/retirement/Roth%20403b/TaxDiversificationandRoth403b.pdf

Williamson, Della, "Roth 401(k) Option"; White paper located in the NAGDCA Clearinghouse.

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