



## IS ROTH RIGHT FOR YOUR PLAN?

**PARTICIPANTS CAN NOW CONTRIBUTE TO THEIR 401(K) ACCOUNTS ON A PRE-TAX AND AFTER-TAX BASIS. WE'LL HELP YOU DETERMINE IF ROTH CONTRIBUTIONS ARE RIGHT FOR YOUR PLAN.**

### Is Roth Right for Your Plan?

Roth 401(k) provisions provide a new way for your employees to save for their retirement. While Roth contributions are similar in many ways to traditional employee contributions, the tax treatment of traditional contributions and Roth contributions differ significantly.

- Traditional employee contributions are made on a pre-tax basis. The employee pays taxes only when the funds are withdrawn from his or her account, presumably at retirement. At that time, the employee is taxed on the entire withdrawal amount, including the original contribution and any earnings that have accumulated.
- Roth contributions are made by the employee on an after-tax basis. While the employee has to pay taxes up front, when the funds are withdrawn (again, presumably at retirement), the employee does not owe any taxes on the original contributions or, significantly, on any earnings that have accumulated.

The potential to withdraw the earnings on Roth contributions on a tax-free basis is one of the primary reasons a participant would want to make Roth contributions rather than, or in addition to, Traditional contributions. But Roth contributions are not right for everyone and adding Roth contributions to your plan can increase the complexity of your plan. Whether the benefits outweigh the potential costs will depend on the nature of your plan and your participant population.

## When Would Your Participants Benefit From Making Roth Contributions Rather than Traditional Contributions?

While there is no single defining answer to this question, the main rule of thumb focuses on tax brackets. Taxes are paid on traditional deferrals upon withdrawal while taxes are paid on Roth deferrals at the time of contribution. Many plan participants anticipate that their tax bracket at retirement will be lower than it is currently. If this is true, traditional deferrals will likely serve their retirement needs better since they can make pre-tax contributions when their tax bracket is high and then withdraw the funds at retirement when their tax bracket is lower. Some plan participants, however, may anticipate that their current tax bracket is at least as high or higher than their tax bracket will be at retirement. In this case, Roth deferrals may be better for them since they will be able to make qualified withdrawals of both contributions and earnings without any tax consequences.

Table 1 highlights the importance of tax brackets. In this example, the participant's expected tax bracket at retirement is 25%. If their tax bracket at the time of their contributions is also 25%, then all else being equal, Traditional and Roth contributions will result in an equal retirement distribution (Compare Column A to Column C). Many participants, however, anticipate that their current tax bracket is higher than their retirement tax bracket will be. For these participants, Traditional contributions make more sense than Roth contributions (Compare Column A to Column D). For some participants, however, their current tax bracket may be higher than their expected retirement tax bracket. For these people, their retirement distribution would be greater if they make Roth rather than Traditional contributions (Compare Column A to Column B).

Of course, none of us can predict the future so it is not necessarily clear what a participant's tax bracket will be when they retire. As a plan sponsor, it makes sense for you to consider your participant population. If you have participants that are likely to have significant income potential at retirement so that their tax bracket may increase at retirement, adding the ability to make Roth Contributions would be a real benefit to these individuals.

**IF A PARTICIPANT INTENDS FOR THEIR RETIREMENT ACCOUNT TO BE AN ASSET FOR THEIR BENEFICIARIES, ROTH CONTRIBUTIONS MAY ALSO MAKE SENSE BECAUSE THEIR BENEFICIARIES WILL NOT HAVE TO PAY TAXES UPON THEIR INHERITANCE.**

**Table 1: When Do Roth Contributions Make Sense?**

	TRADITIONAL (PRE-TAX) 401(K) ACCOUNT	ROTH (AFTER-TAX) 401(K) ACCOUNT		
	A	B	C	D
Current Tax Bracket		15%	25%	35%
Contribution Amount	\$5,000	\$5,000	\$5,000	\$5,000
Federal Taxes paid at time of Contribution <sup>1</sup>	\$0	\$750	\$1,250	\$1,750
Net Contribution	\$5,000	\$4,250	\$3,750	\$3,250
Value in 20 Years <sup>2</sup>	\$23,305	\$19,809	\$17,478	\$15,148
Federal Taxes paid at Retirement (25% tax bracket) <sup>1</sup>	\$5,826	\$0	\$0	\$0
Net Distribution	\$17,479	\$19,809	\$17,478	\$15,148

1. State income taxes may also apply.

2. Assumes annual rate of return of 8%.



## Adding Roth Contributions to Your Plan.

To add Roth contributions to your plan, there are several things you will need to do. First and foremost, you will need to determine if your payroll system is capable of handling after-tax deferrals and producing a payroll report indicating the amount of each participant's Roth contributions, separate from their Traditional contributions and any other plan contributions such as an employer match. If you cannot produce the necessary information on your end, you won't be able to fulfill your responsibilities as plan sponsor.

Second, you will need to formally amend your plan to allow Roth contributions. As part of this process, we will meet with you to discuss several policy decisions you will need to make. For example, will you allow participants to split deferrals between Traditional and Roth contributions, or will the plan only allow one type or the other at any one time?

Finally, you will need to communicate the addition of Roth contribution provisions to your plan participants. While the ability to make after-tax contributions can significantly enhance your plan, the additional complexity may also be a source of confusion for some of your participants. Capital's customer service team and informative educational materials can help!

## What Else Should You Know?

Like Traditional contributions, there are many rules and limitations that apply to Roth contributions. Here's a few of the more important ones:

- **The earnings on Roth contributions are non-taxable only if such distribution is a “qualified” distribution.** A qualified distribution is triggered by one of only three events: attainment of age 59½, death, or disability. Further, to be qualified, the distribution must occur at least 5 years after the participant's first Roth contribution. This means that distributions occurring prior to this 5-year period or on account of severance from employment or hardship, for example, would not be qualified distributions. If a distribution is non-qualified, the accumulated earnings on the Roth contributions are taxable.
- The 401(k) contribution limit (\$15,500 for 2008) is applicable to all elective deferrals, including Roth contributions. This means that participants are still only able to defer a total of \$15,500, whether in Roth deferrals or Traditional deferrals.
- For a participant that is eligible for them, catch-up contributions can be made as Traditional contributions or as Roth contributions.
- Once a deferral is designated as a Roth deferral, the participant cannot change their mind.
- The major compliance tests (including the ADP and ACP tests) consider all elective contributions, including Roth contributions.

## Interested? Contact Capital Retirement Plan Services today!

Any tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed herein.

©2008 Capital Retirement Plan Services, Inc. This bulletin is published as a general informational source. This information is general in nature and is not intended to constitute legal advice in any particular matter. Capital Retirement Plan Services, Inc. does not warrant and is not responsible for errors or omissions in the content of this report.

\*



WWW.CAPITALRETIREMENTPLANS.COM

800.878.5220

103A Solana Road • Ponte Vedra Beach, FL 32082