Strategic Benefit Services

Just the FAQs
for Plan Sponsors

8 Questions Plan Sponsors Should Ask About Adding a Roth Feature

1. What is a Roth?

According to the 2015 *PLANSPONSOR* Defined Contribution Survey, 62% of all defined contribution plans, across multiple industries now offer a Roth feature. Among 403(b) plans, 54.7% have adopted this popular design feature. A Roth is not a separate retirement plan, but simply an additional source of contributions accepted by the plan and record-kept separately so the rules applicable to Roth contributions can be followed. Once adopted, plan sponsors must give participants an opportunity at least once per plan year to make designated Roth contributions.

The basic difference between a traditional 401(k) or 403(b) and a Roth is when a participant pays taxes. Within a traditional 401(k) or 403(b), participants make contributions with *pre-tax* dollars, and receive a tax break up front, effectively lowering their current income tax bill. Their contributions and earnings grow tax-deferred until they take a distribution. At that time, withdrawals are considered to be ordinary income and participants pay taxes based upon their effective tax rate at the time of the distribution. They'll also be required to pay a 10% early withdrawal penalty unless they're over 59 ½ years of age.

With a Roth, it's basically the opposite. Participants make contributions with after-tax dollars, foregoing the upfront tax deduction. However, as long as they are 59 ½ years of age and have held the account for five years, they may be eligible (subject to the plan's withdrawal provisions) to take qualified withdrawals from their account and avoid paying income tax. Since Roth contributions are made with after-tax dollars, participants do not need to pay income taxes again on that portion of the withdrawal and there will be no taxes assessed on the portion of the withdrawal attributable to earnings.

2. What types of employees might this appeal to?

- Traditionally, a Roth account has been deemed suitable for young investors who may be in a lower tax bracket. They might be more apt to forgo the up-front tax deduction of a traditional 401(k) or 403(b) for the future benefit of tax-free withdrawals from the Roth since they have multiple years in which to invest and see their balances accumulate.
- Typically, the traditional 401(k) or 403(b) account has appealed to participants who anticipate being in a lower tax bracket when they retire and start taking distributions. However, participants should keep in mind that even if they anticipate being in a lower tax bracket when they retire, large withdrawals from their traditional retirement accounts could move them into a higher tax bracket. Having some tax-free withdrawals from a Roth source could be appealing.
- Unlike a Roth IRA, a Roth 401(k) or 403(b) is **not** subject to income limits. In 2016, the income phase-out for single filers looking to contribute to a Roth IRA starts at $117,000 and for married filers the income threshold starts at $184,000. Therefore, highly compensated employees who may not be eligible to contribute to a Roth IRA due to the applicable income limits, would be able to utilize the Roth feature within the plan and benefit from tax-free withdrawals in retirement.

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- Participants interested in **estate planning**, or who want to leave their retirement assets to their heirs might find the Roth appealing. All 401(k) and 403(b) accounts are subject to required minimum distributions (RMDs) at the later of the attainment of age 70 ½ or separation from service. However, RMDs from a Roth 401(k) or 403(b) can be avoided by rolling over the money to a Roth IRA prior to the time such distributions would be required from the 401(K) or 403(b) account. This may provide greater flexibility in estate planning and inter-generational wealth transfer strategies than Traditional IRA Rollovers.

3. What are the limits?

The combined contribution limit for **both** after-tax Roth contributions and pre-tax 401(k) contributions is set by Internal Revenue Code Section 402g. The limit in **2016 is $18,000 plus an additional $6,000 catch up** contribution for participants who will be age 50 or older by the end of the year. If the plan allows it, participants can make both traditional pre-tax and Roth contributions within the same tax year. They just can't exceed the limits. Participants may also be eligible to contribute to either a Traditional and/or Roth IRA outside of the plan if they qualify.

4. What is an in-plan Roth conversion?

An in-plan Roth conversion or rollover is a reclassification of non-Roth funds to Roth within the plan. The plan will need to include general Roth provisions and allow for in-plan Roth conversions. The American Taxpayer Relief Act of 2012 amended the requirement that employees wait until a distributable event (i.e., age 59½, termination, death or disability) for an in-plan Roth conversion. With the release of *Notice 2013-74,* the Internal Revenue Service (IRS) provided additional guidance on in-plan Roth conversions. Any vested balance, including earnings, can be converted to a designated Roth account. Any amounts converted remain subject to the same distribution restrictions that were applicable before the in-plan conversion. The participant must report the amounts converted to Roth as taxable gross income for the year of the conversion and pay the income tax due. However, the converted amount is not subject to the 10% penalty for early withdrawal and the in-plan Roth conversion is not subject to the mandatory 20% withholding rules.

5. Can employers make a match on a participant's Roth contributions?

The plan design will determine whether the employer will make an employer matching contribution on the participant's Roth contribution. However, the employer's matching contribution is made on a pre-tax basis and earnings on the employer contribution are taxable upon distribution.

6. Can an employee take a loan?

Yes, the plan's loan policy may allow loans from Roth sources

7. Can an employee roll money into their Roth source?

Yes, the plan's amendment establishing the Roth provision can allow for rollovers into the plan from approved Roth sources.

8. How would you establish a Roth feature in your Plan?

A Roth feature can be added to a retirement plan at any time by amending the plan. It would be important to determine how the adoption of a Roth will impact the administration of your plan. Payroll files being transmitted to your retirement plan's record-keeper will need to be updated. It would be prudent to effectively communicate the addition of the Roth feature to your participants and ensure your plan's education materials are updated accordingly.

Contact your retirement plan consultant at SBS to help you determine whether the adoption of a Roth feature would be advisable for your plan.

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