

Roth: A new 401(k) option

*Starting in 2006,
you'll be eligible
for this great
benefit, which lets
earnings grow tax-free.*

By David J. Schiller, JD

Do you offer a 401(k) plan in your practice, or do you participate in one where you work? Then you're familiar with the benefits of these plans. Participants contribute a portion of their income through salary deferral. So contributions are made on a pre-tax basis, which means they're excluded from taxable income. But when you withdraw money from the plan, it's taxed at ordinary income rates.

Starting next year, you may be able to avoid this tax pitfall. Beginning in 2006, 401(k) plans (and 403(b) plans sponsored by tax-exempt organizations) can allow employees to make Roth contributions to their plans. You've probably heard of the Roth IRA, although there's a good chance you haven't been able to contribute to one because your income is too high. Well, Roth 401(k) contributions work by a whole different rulebook—one that doesn't prohibit people from participating because they earn too much.

Because Roth 401(k) contributions are made with

after-tax compensation, there's generally no tax due when you withdraw your contributions and earnings from the plan. So the earnings end up being tax-free, rather than simply tax-deferred as they are with traditional 401(k)s. (However, making Roth after-tax contributions won't reduce your tax bill for the year you made the contribution as traditional 401(k) contributions will.)

You might be interested in adding Roth contributions to your 401(k) plan either for yourself, or as something to offer your staff members if you're in a small group practice. (See page 81 to find out what's involved in permitting Roth 401(k) contributions.)

Interested? Here's what you need to know.

Contribution limits and eligibility

Beginning next year, Roth contributions to a 401(k) plan will have the same limit as traditional 401(k) contributions: \$15,000 (plus a catch-up contribution of \$5,000 for people 50 and over). After 2006, these contribution amounts will be indexed for inflation in \$500 increments. And income limits don't apply. You can make Roth contributions to a 401(k) plan no matter how much you earn. (These contributions won't affect your ability to contribute to a traditional Roth IRA also, if you're eligible.)

But understand that the \$15,000 contribution is the combined limit for *all salary deferral* contributions to a 401(k) plan. You can't contribute \$15,000 in traditional pre-tax contributions plus *another* \$15,000 in Roth contributions. You could, though, contribute \$10,000 in pretax contributions and \$5,000 in Roth contributions. The same applies to catch-up contributions for participants age 50 and over. You can make a \$5,000 Roth catch-up contribution or \$5,000 in additional pre-tax contributions or your

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Power Points

- Roth contributions to a 401(k) plan will have the same limit as traditional 401(k) contributions: \$15,000.
- The \$15,000 contribution is the combined limit for *all salary deferral* contributions to a 401(k) plan.
- You can make Roth contributions to a 401(k) plan no matter how much you earn.
- If you expect tax rates to be higher when you withdraw the money, then you may be better off making Roth contributions.

catch-up can be a combination of both, but your *total* catch-up contribution can't be more than \$5,000.

Is one type of contribution better than the other? There's no simple answer to this question, although the higher your earnings, the more attractive a Roth becomes. But, ultimately, whether you'll be better off making Roth contributions rather than traditional 401(k) contributions depends on your age, your financial circumstances, your tax bracket, and whether and when you'll need to access the account.

The answer also depends on what you expect your investments to earn, as well as the tax rate you anticipate when the funds are withdrawn. For example, if you expect tax rates to be higher when you withdraw the money (because of changes in the law, fewer deductions, or higher income), then you may be better off making Roth contributions.

What you need to know about distributions

The same distribution restrictions apply to Roth contributions as to traditional pre-tax contributions. In general, a distribution may only be made upon death, disability, or termination of employment; when the participant reaches 59½; or upon a hardship (such as to prevent eviction or to pay for uninsured medical expenses). It's up to the employer whether a plan will permit distributions for any or all of these events.

Unlike contributions to a Roth IRA, Roth contributions to a 401(k) plan are subject to the rules that apply to 401(k) plans, so they may be used to make participant loans and to purchase life insurance for the participant. Again, the employer has the option to allow these benefits—or not.

When you withdraw money from your 401(k), the principal and earnings on the Roth contributions aren't taxable as long as the distribution is "qualified" which means that you're age 59½ or over, you're disabled, or they're being paid because you've died. Also, to be qualified, five years must have passed since your first Roth contribution to a 401(k) plan.

Earnings on the Roth contributions will be taxable as ordinary income *and* you may owe a 10 percent penalty if you receive a distribution that isn't "qualified" and you fail to properly roll it over. Roth 401(k) distributions may only be rolled over to a Roth IRA or to another 401(k) plan that will accept the rollover.

Roth 401(k) plan participants must generally begin taking distributions from the plan no later than age 70½, unless they've rolled the Roth 401(k) proceeds into a Roth IRA, which doesn't have a minimum distribution requirement. ■

When you're the plan's sponsor

If you're in a position to make decisions about your practice's retirement plan, the first decision to make is whether to offer a Roth 401(k). Some physicians may hesitate because the benefit is scheduled to expire after 2010. If Congress doesn't choose to extend the Roth 401(k), you won't be able to make additional Roth contributions (although any contributions and earnings already in a plan could stay there).

If you decide to offer the Roth 401(k), there are additional considerations. First, the plan must be amended to permit Roth contributions. Second, if you have employees, you'll need communications materials and enrollment forms. Your plan administrator should provide these. Third, you'll need to make sure that your payroll system and service providers are able to accommodate Roth contributions.

There are special rules that apply to Roth contributions:

► A participant must identify a Roth contribution as such when he makes it (usually on an election form that the plan administrator provides). If the plan permits both traditional and Roth contributions, then the deferral election form will require the employee to indicate how much of his salary deferral is a traditional 401(k) contribution and how much is a Roth. Once a contribution is made based on the election, it's irrevocable. However, you can make a different allocation for future contributions when the plan allows election changes.

► Because a Roth contribution is post-tax, it must be included in the employee's income at the time of deferral (by treating the deferral as wages subject to withholding).

Other than the tax treatment, Roth contributions are treated the same as pre-tax contributions. The same nondiscrimination tests and design features apply. For instance, if your practice makes matching contributions on behalf of employees, these matches must be in the form of traditional 401(k) pre-tax contributions, even if an employee is only making Roth 401(k) contributions. Make sure that employees understand that distributions of these matching contributions will be taxable as ordinary income.