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TO ROTH OR NOT TO ROTH

That is a question that has come up in many plan sponsor offices. If one employee decides he/she wants to contribute Roth 401(k) deferrals, is it worth the additional cost and administrative effort to add this provision to the plan? Remember, many people can contribute to a Roth IRA.

Each company has its own reasons for wanting to allow Roth contributions or not, but it is important in any scenario to weigh the pros and cons of this additional administrative undertaking. If your plan already includes a Roth 401(k) provision, this will serve as a refresher of the rules and taxation applicable to those contributions.

ADMINISTRATIVE CONSIDERATIONS

First, you need to realize that it is the employer's/plan sponsor's responsibility to ensure contributions are deposited to the correct money types in the Plan account, and are subsequently tracked and taxed properly. Most payroll companies have a system for deducting Roth contributions from employees' salary, but with any system, mistakes can be made, so you want to monitor the deductions closely.

Submitting deposits to the plan timely and correctly is imperative. Aside from the penalties associated with late deposits, if a deposit error is made and a correction must be done, the contributions to the Roth account must be corrected to reflect contributions and earnings appropriately in the system or those amounts may not get credited properly. This could result in a participant paying the wrong tax or even paying tax twice on Roth contributions. In other words, pay close attention to deposit processing to avoid errors.

The total of both a participant's pre-tax and Roth 401(k) deferrals cannot exceed the IRS 402(g) limit ($17,500 in 2013).

Additional issues to consider include ADP refunds, 415 excess additions, Required Minimum Distributions (70 ½), loans, and in-service or hardship withdrawals. All of these items can be dealt with, but they do require additional calculations to ensure taxation is handled properly. We strongly recommend restricting loans, in-service and hardship withdrawals to pre-tax monies only as a method of limiting nonqualified distributions and tax penalties.

WHAT IS A QUALIFIED ROTH 401(k) DISTRIBUTION?

Participants must understand that **earnings in a Roth 401(k) account are only tax free if distributed as a Qualified Roth Distribution**.

Please be aware that in order to receive a **Qualified Roth Distribution** <u>both</u> of the following requirements must be satisfied:

1. The participant must have a Qualifying Event, which would be: attainment of Age 59 ½, Death, or Disability
2. The Qualifying Event must occur after completion of the 5 tax year period. The 5 tax year period begins with the first taxable year in which a designated Roth contribution was made to that participant's plan account.

If money is distributed before a qualifying event occurs, it is a nonqualified distribution and only the principal amount is tax free.

QUALIFIED VS. NON-QUALIFIED DISTRIBUTIONS

Following is a brief description of the taxation differences between a Qualified Roth Distribution versus a Non-Qualified Roth Distribution:

Qualified Roth Distribution	Nonqualified Roth Distribution
No tax on principal (basis)	No tax on principal (basis)
No tax on earnings	Ordinary tax on earnings
No 10% early withdrawal penalty	10% early withdrawal penalty on earnings
No mandatory 20% federal withholding	Mandatory 20% federal withholding on earnings

ADDING ROTH 401(k) PROVISIONS

If you would like to add a Roth 401(k) option to your plan, the plan document must be amended to allow this. There is a cost for an amendment, so you want to be sure your participants will actually use the option if you are going to add it.

As with all qualified plan matters, be sure to do your research and determine if Roth 401(k) is appropriate for your plan.