

Roth 401(k) Option Now Permits Tax-Free Distributions

Starting January 1, 2006, Section 401(k) plans can be amended to permit participant 401(k) contributions (elective deferrals) to be treated like a Roth IRA contributions. This means that participants in a “Roth 401(k)” plan can choose to put some or all of their elective deferrals in a Roth 401(k) account – and, if the account is maintained for at least five years – receive benefit payments at any time after age 59½ that are tax-free. This feature is available even to high income participants who are otherwise prohibited from making current Roth IRA contributions. Even better, the Roth 401(k) is not subject to the mandatory distribution rules that apply to other retirement plans. So, if a participant rolls a Roth 401(k) account into a Roth IRA at retirement, distributions can be postponed indefinitely and then be paid to a death beneficiary, also on a tax-free basis.

Annual contributions to a Roth 401(k) plan are subject to the same annual limits as 401(k) elective deferrals, but there is one limit for both kinds of contributions. For 2006, that limit is \$15,000 with an additional “catch-up” contribution of up to \$5,000 for participants age 50 and older. Also, participant contributions to Roth 401(k) plans are *not* excluded from current income like participant 401(k) elective deferrals, so those contributions are taxed to the participant now.

The loss of the current income tax exclusion for Roth 401(k) contributions is significant. This suggests that the Roth 401(k) may appeal to younger participants in lower income tax brackets. However, there is no income limit for making contributions to a Roth 401(k) plan as there is for a Roth IRA. Consequently, some high bracket participants may be interested in making Roth 401(k) contributions – especially if they think income tax rates will increase between now and the time they take distributions of their Roth 401(k) benefits. At least one major Chicago law firm has decided to add a Roth 401(k) feature to its existing Section 401(k) plan, and a number of other employers are looking into the Roth 401(k) for their employees.

Recommendation: The Roth 401(k) plan may not appeal to all employers. Administrative complexity and the challenge of communicating the terms of a Roth 401(k) plan to employees keeps some employers from taking the plunge. However, many employers are taking a close look at the Roth 401(k) and some are finding that it is a good option for their senior management employees.

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