

## The Roth 401(k)



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Often have agents tell me that their clients are looking for a Roth IRA but don't like the fact that they're limited to \$3,000 a year. They want more, and understandably so. Fortunately, deep within the tax relief act of 2001 comes the answer . . . the Roth 401(k).

### What Is the Roth 401(k) Feature?

Roth 401(k)? You've read correctly. The Roth 401(k) comes into effect on January 1, 2006, as specified by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). This feature allows each participant to designate all or a portion of his or her salary deferral to be either pre-tax or a "qualified Roth election."

Unlike Roth IRAs, there are no AGI limits to use the new opportunity "Roth" 401(k). Thus everyone can take advantage of this new feature. Roth 401(k) plans are getting more attention as firms and individuals think about their potential value.

It may be worth spending some time considering the implications of the Roth 401(k) so that you and your clients are ready to go when regulations are finalized.

With the addition of the new Roth feature, there will be some confusion regarding the differences between a traditional 401(k) elective deferral and the Roth 401(k) feature. The Roth 401(k) rules are similar to those for the Roth IRA, but there are some important differences.

In a Roth 401(k), income taxes are paid at the participant's regular income tax rates at the time of contribution. Also, earnings and withdrawals are not taxed if withdrawals begin after age 59 1/2 and if five years have elapsed from the date of the first contribution to the plan. Taxes and penalties are waived if a participant dies or is disabled. An active participant of the 401(k) must take minimum distributions beginning the year after they turn 70 1/2 if they are a 5 percent owner. However, a Roth 401(k) can be rolled into a Roth IRA if the participant leaves the company, relieving the participant from taking minimum distributions—a noteworthy planning option.

*"A Roth 401(k) allows for a higher contribution than a Roth IRA . . ."*

The Roth 401(k) allows participants to contribute up to \$15,000 in deferrals in 2006, and another \$5,000 in catch-up deferrals if they are over age 50. For example, your client turns 50 in 2006 and is in the 33% federal tax bracket. Your client would have paid \$6,600 in federal income taxes

on that \$20,000 in income. If your client maxed out his or her contributions for the five years the Roth plan is scheduled to run, he or she will have \$100,000 in contributions in the Roth 401(k), and have already paid the taxes on that amount. No taxes will be owed on qualified withdrawals, and if the client has invested wisely, the Roth 401(k) has grown.

You may be asking why your client should go with a Roth 401(k). It's easy really—a Roth 401(k) allows for a higher contribution than a Roth IRA, and for individuals who would like tax free distributions, the Roth 401(k) offers the chance. Keep in mind that your client can blend the Roth 401(k) feature with traditional pre-tax existing 401(k) deferrals creating added planning opportunities. This new feature may have great appeal to younger participants who can accrue a substantial Roth 401(k) balance before retirement.

### Purchasing Life Insurance

The question will invariably arise as to whether your client can purchase life insurance with the Roth 401(k) feature. There has been no mention of life insurance in the proposed regulations, but that could change at a moment's notice.

Security Mutual believes that life insurance should not be purchased with qualified Roth 401(k) deferrals. However, SML strongly promotes the purchasing of life insurance in profit sharing, matches and deductible deferrals. There may be no apparent tax advantage to purchasing life insurance in the Roth feature, since the client is

already using after-tax dollars. The client might as well purchase the life policy outside of the Roth option where he or she is not limited to any incidental death benefit limits. Furthermore, he or she won't have access to the termination options available when purchasing qualified life.

*“... your clients have options when they terminate their pension plans; they don't have to simply surrender their policies.”*

Purchasing qualified life insurance gives your client the ability to use pre-tax dollars, which makes it affordable and convenient—not to mention the appeal of purchasing life insurance in your clients' Profit Sharing or DASH plans. Furthermore, your clients have options when they terminate their pension plans; they don't have to simply surrender their policies.

## **On the Administrative Side**

If your client decides to go ahead and add the Roth 401(k) feature to his or her own plan, there are a few administrative issues to keep in mind.

An existing 401(k) plan would need to be formally amended to add the Roth option.

Payroll records will also need to reflect after-tax Roth 401(k) contributions separately from pre-tax 401(k) contributions. The Plan Administrator must be notified to begin separate tracking and record keeping for the Roth and traditional 401(k)s.

To help you and your clients, many providers may sponsor a Roth 401(k) analyzer. Security Mutual's Marketing Department can help you analyze whether a 401(k), DASH 401(k) or Micro(k) with the Roth feature is an appropriate option for your client. It's as easy as completing an SML Fact Finder and returning it to 607-772-6726. If you need one of our fact finders, you can locate it on SecurityLink or in the download section of [www.microk.biz](http://www.microk.biz).



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