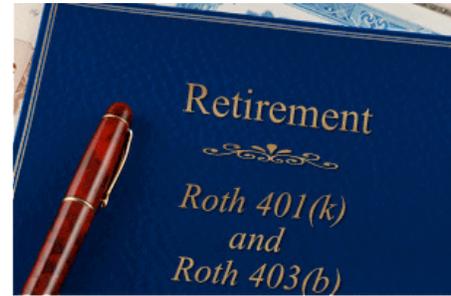

Qualified Roth Contribution Program

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) contained a new code section, IRC Sec. 402A, which allowed an employer to add a “qualified Roth contribution program” to a regular IRC Sec. 401(k) or IRC Sec. 403(b) qualified retirement plan.¹ The Small Business Job Act of 2010 (SBJA) added IRC Sec. 457(b) governmental plans to the list of retirement plans authorized to offer a qualified Roth contribution program.²



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Under a regular 401(k), 403(b), or 457(b) governmental plan, a participant chooses to defer a portion of his or her compensation into the plan. Such “elective deferrals” are made on a pre-tax basis, any account growth is tax-deferred, and withdrawals are taxed as ordinary income.

In a qualified Roth contribution program, a participant can choose to have all or part of his elective deferrals made to a separate, designated Roth account. Such “designated Roth contributions” are made on an after-tax basis. Growth in the designated Roth account is tax-deferred and qualified distributions are excluded from gross income. Other points:

- Separate accounting and recordkeeping are required for the deferrals under the regular, pre-tax portions of a plan and for those made to the designated Roth account.
- Individuals whose adjusted gross income exceeds certain limits may not contribute to a regular Roth IRA. There are no such income limits applicable to a designated Roth account.
- For 401(k) plans, contributions to a designated Roth account are elective deferrals for purposes of the Actual Deferral Percentage (ADP) test.

¹ The discussion here concerns federal income tax law. State or local income tax law may differ.

² Effective January 1, 2011.

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Contributions

A number of rules apply to contributions to a qualified Roth contribution program:

- **Dollar limitation:** For 2015, a maximum of \$18,000 may be contributed. Those who are age 50 and older may make additional contributions of \$6,000. A participant may choose to place all of his or her contributions in the regular, pre-tax portion of a plan, all in the designated Roth account, or split the deferrals between the two.
- **Employer contributions:** Employer contributions will be credited to the regular, pre-tax portion of a plan; they may not be designated as Roth contributions.
- **Excess contributions:** Excess deferrals to a designated Roth account must be distributed to the participant no later than April 15 of the year following the year in which the excess deferral was made. Otherwise, the excess deferral will be taxed twice, once in the year of deferral and a second time the year a corrective distribution is made.

Distributions

A distribution from a designated Roth account will be excluded from income if it is made at least five years after a contribution to such an account was first made and at least one of the following applies:

- The participant reaches age 59½;
- The participant dies;
- The participant becomes disabled.

Such distributions are known as “qualified” distributions. Other points:

- **Nonqualified distributions:** If a distribution does not meet the above requirements, it is termed a “nonqualified” distribution. Such distributions are subject to federal income tax, including a 10% premature distribution penalty if the participant is under age 59½ in the year the funds are distributed. Such distributions are taxed under the annuity rules of IRC Sec. 72; any part of a distribution that is attributable to earnings is includable in income; any portion attributable to the original investment (basis) is recovered tax-free. This contrasts sharply with the taxation of nonqualified distributions from a regular Roth IRA account. Nonqualified distributions from a regular Roth IRA are taxed following pre-defined ordering rules under which basis is recovered first, followed by earnings.

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- **First-time homebuyer expenses:** In a regular Roth IRA, a qualified distribution may be made to pay for first-time homebuyer expenses. This provision does not apply to distributions from a designated Roth account.
- **Rollovers to designated Roth accounts:** SBJA also contained a provision that allowed a distribution from the regular, pre-tax portion of a plan to be rolled over into a designated Roth account.¹ The individual (plan participant or surviving spouse) must include the distribution in gross income (subject to basis recovery) in the same manner as if the distribution from the pre-tax plan had been rolled over into a Roth IRA.
- **Rollovers from designated Roth accounts:** A distribution from a designated Roth account may only be rolled over into a Roth IRA or another designated Roth account. Such a rollover is not a taxable event.
- **Required minimum distributions:** Generally, amounts in a designated Roth account are subject to the required minimum distribution rules applicable to plan participants when they reach age 70½. However, a participant can avoid the mandated distributions by rolling over amounts in the designated Roth account into a regular Roth IRA.

Which Account To Choose?

The decision as to which type of account should be used will generally be made on factors such as the length of time until retirement (or until the funds are needed), the amount of money available to contribute each year, the participant's current tax situation, and the anticipated marginal tax rate in retirement. An important issue to keep in mind is the overall, lifetime tax burden.

- **Regular 401(k), 403(b), or 457(b) governmental plan:** Generally, individuals with a relatively short period of time until retirement, or who expect that their marginal tax rate will be lower in retirement, will benefit more from a regular, pre-tax qualified retirement plan.

¹ This portion of SBJA was effective for distributions after September 27, 2010.

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- **Designated Roth account:** Younger individuals with more years until retirement and those who anticipate that their marginal tax rate will rise in retirement will generally benefit more from a designated Roth account. The fact that contributions to a designated Roth account are after-tax may cause current cash-flow problems for some individuals. Higher income participants may find that taxable income will be higher with a designated Roth account than with a regular pre-tax plan, potentially reducing tax breaks such as the child tax credit or AMT exemption.
- **Both:** Some individuals may choose to contribute to both types of plan, to provide flexibility in retirement.

Seek Professional Guidance

Because of the complexities involved, the guidance of tax and financial professionals is strongly recommended.