THE EVOLUTION OF THE ROTH 401(K)

I. WHAT IS A ROTH 401(K)?

A. Legislative History.

1. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") authorized the establishment of Roth 401(k) accounts.

2. Although enacted in 2001, EGTRRA specifically waited for the implementation of Roth 401(k) until 2006. EGTRRA is due to sunset at the end of 2010 unless legislation is enacted.

3. Roth Individual Retirement Accounts ("Roth IRAs") have become a popular means for taxpayers below certain income thresholds ($110,000 for single individuals, $160,000 for married individuals) to put aside after tax dollars in their IRAs.

4. The contributions can grow without being subject to tax in the future.

5. Besides the income threshold limiting contributions to Roth IRAs, the maximum amount that the individuals can contribute is limited to $4,000 in 2005 ($4,500 for individuals age 50 or older in 2005).

B. What is it?

1. A designated Roth contribution will give 401(k) plan participants the opportunity to defer some of their wages into a 401(k) plan as Roth contributions.

2. Roth 401(k) contributions will be included in a participant's income and will be taxed the year the contributions are made, but qualified Roth 401(k) distributions (including earnings) will be tax free similar to distributions from Roth IRAs.

C. General Advantages.

1. The eligibility to make contributions is not restricted by a participant's income level.

2. The contribution limits are higher.

3. Subject to the terms of a 401(k) plan, the most a participant can contribute as a Roth 401(k) contribution for 2006 is $15,000, plus up to $5,000 in catch-up contributions if the participant is age 50 or older. These are the same contribution limits that apply to pre-tax elective 401(k) deferrals.

4. The maximum Roth 401(k) contribution and pre-tax 401(k) contribution are aggregated and limited to the maximum limit under Section 402(g) of the Code.

II. THE MECHANICS

A. General Rules.

1. Roth 401(k) contributions are defined as contributions under a qualified cash or deferred arrangement ("CODA") that are:

a. Designated irrevocably as Roth contributions by the participants at the time of the CODA election.

b. Treated by the employer as includable in the participant's wages at the time the participant would

have received the cash if not contributing the funds to the plan; and

c. Maintained in separate accounts.

2. The irrevocable election to treat elective contributions as Roth contributions will not permit plan participants to later claim that contributions should have been pre-tax deferrals.

3. The IRS guidance indicates that the employer must treat Roth 401(k) contributions as wages subject to withholding requirements.

4. A plan must separately account for Roth 401(k) contributions. The IRS guidance indicates that Roth contributions and distributions must be credited and debited to a participant's Roth account, and that a plan must maintain a record of the basis (contributions) and earnings within a Roth account.

5. Earnings, losses, and other credits or charges applicable to Roth contributions must also be separately allocated to a participant's Roth 401(k) account.

B. Other Rules for Roth 401(k) Contributions.

1. Forfeitures that are typically allocated to participants' accounts in a retirement plan may not be allocated to Roth 401(k) separate accounts.

2. Roth 401(k) assets may only be rolled over either to another designated Roth account or to a Roth IRA.

3. Although Roth 401(k) assets may only be distributed when a participant has a distribution event under the plan, this does not necessarily mean that the Roth assets will be distributed tax

free. Roth 401(k) assets must also satisfy certain qualified distribution requirements under Section 402A(d)(2) of the Code. Specifically, a distribution of Roth 401(k) assets will be considered qualified only after the 5-year requirement is met, and the participant reaches age 59 ½, dies or becomes disabled.

4. Distributions taken within the 5 year period, referred to as the "non-exclusion period," may subject the earnings to taxation. The 5-year holding period begins with the earlier of:

    a. The first taxable year for which the participant made Roth contributions to the distributing retirement plan, or

    b. The first taxable year the participant made Roth contributions to a former employer's retirement plan, which was rolled over to the distributing retirement plan.

III. ADP TESTING

A. ADP Test.

1. Roth 401(k) contributions must be included in the actual deferral percentage ("ADP") test, as well as in other required tests (e.g. top-heavy, annual additions, etc.) in the same manner as pre-tax elective deferrals.

2. When correcting an ADP test failure, a plan may permit a highly compensated employee who has made both Roth contributions and pre-tax elective deferrals in the applicable year to choose whether the distribution of excess contributions will consist of Roth contributions or pre-tax deferrals.

3. Roth 401(k) contributions that are distributed as corrective distributions are not qualified distributions. Roth contributions

(basis) will not be taxable to the participant, but earnings associated with the distribution will be.

B. Other Tax Related Issues.

1. Unlike the Roth IRA, Roth 401(k) contributions are subject to the minimum required distribution rules of Section 401(a)(9) of the Code.

2. Although matching contributions may be made on Roth contributions, the matching contributions are tax deferred rather than tax-exempt from taxation. This is the same rule that would apply for a matching contribution made on behalf of a traditional elective deferrals.

IV. ACTION PLAN

A. Steps to Incorporate.

1. Adjust the plan's record keeping and payroll system to separately account for Roth contributions.

2. Prepare and distribute employee communications describing the benefits of Roth contributions, including a revised Summary Plan Description or a Summary of Material Modifications. Effective communications will be important in explaining this new option to employees.

3. Obtain new deferral election forms from participants prior to the time that Roth contributions are permitted.

4. Amend the plan to provide for Roth contributions, including provisions detailing the order in which the distributions were made from pre-tax deferrals and Roth contributions. Plans

must be amended by the end of the plan year in which Roth contributions are first permitted.

B. Complexity and Expenses to Consider.

1. Employers will have to require each employee to elect what portion of their 401(k) deferral should be treated as Roth contributions and what amounts should be traditional pre-tax 401(k). This additional option will double the employer's record keeping in order to track these elections in addition to the contribution elections.

2. These separate elections will have to be set up in the employer's payroll system and treated differently. Roth contributions will have to be taxed, traditional 401(k) not taxed.

3. The Roth and 401(k) contributions will have to be identified separately when plan contribution data is submitted to the plan's record keeper. The IRS requires plan record keepers to track the Roth account separately from the other plan accounts. Record keepers will have to track Roth contribution "basis". These requirements mean record keepers must add additional plan account records resulting in higher record keeping costs which will be passed on to the participant.

4. When plan distributions are made, if a participant wants to roll over their account to an IRA, they will have to establish two IRAs, traditional and Roth, and see that the distribution is properly allocated between the two accounts. The participant will look to the plan sponsor or plan record keeper for the necessary information to do this.

V. WHO SHOULD BE TAKING ADVANTAGE OF THE ROTH 401(K)?

A. Any employee with a low marginal tax bracket can benefit from the advantage of the Roth account.

B. Young workers with decades to build a nest egg and who would likely be in a high tax bracket in the future.

C. The participant that wants to take advantage of a hidden wealth transfer treasure should consider the Roth. High income taxpayers that cannot contribute to Roth IRAs can fund large sums in the 401(k) plan and then roll the funds into Roth IRAs. Distributions can be deferred until after death. After death the distributions are spread out over the life expectancy of the beneficiary