

Roth 401(k)

The Roth 401(k) feature for 401(k) plans allows participants to save for retirement using the tax benefits previously only afforded to Roth IRAs. The Roth 401(k) was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and made permanent as part of the Pension Protection Act of 2006 (PPA).

The Basics

Saving under the Roth 401(k) is similar to saving under a “regular” 401(k): employees elect to have a certain percentage or amount withheld from their paycheck and contributed to the retirement plan. These regular payroll deductions have historically been made on a pre-tax basis. That is, the participant receives an immediate tax advantage for making the contribution on a tax-deferred basis. However, the payroll deductions for the Roth 401(k) are made on an after-tax basis. As such, the participant pays the taxes on the Roth 401(k) at the time of the contribution and, assuming withdrawal qualifications are met, both the Roth 401(k) contributions and investment earnings are tax-free upon distribution. Depending upon a participant’s individual tax situation, the Roth 401(k) could be a significant tax planning opportunity.

Tax-Free Distribution

A distribution of Roth 401(k) money and investment earnings will be eligible for tax-free treatment when the following two criteria are met: 1) the distribution occurs at least five years following the year the first Roth contribution is made to the plan; and 2) the participant has attained age 59½, dies or becomes disabled. Participants are permitted to roll over their Roth 401(k) balance in the plan into a Roth IRA to maintain the special Roth tax advantages. The same eligibility criteria apply to the Roth IRA.

Contributions

For most plan purposes, Roth 401(k) contributions are treated like regular 401(k) contributions. For example, Roth 401(k) accounts are available for loans and hardship withdrawals (if applicable). Also, the sum of the Roth 401(k) and regular 401(k) contributions cannot exceed \$15,500 for 2008 (\$20,500 if age 50 or over).

Participant Advantages

The Roth 401(k) may interest a variety of participants including:

- Participants who anticipate their federal tax rates will increase in the future.
- Younger and lower-paid participants with low marginal tax rates.
- Higher-paid participants who have not been able to make Roth IRA contributions due to income limits (adjusted gross income for 2008 of \$169,000 for married filing jointly; \$116,000 for single).
- Participants who want to minimize taxable income during retirement (e.g. to avoid Social Security benefits from becoming taxable).
- If rolled to a Roth IRA, no minimum distribution is required, which may permit greater estate planning opportunities.

Plan Sponsor Considerations

As the Roth 401(k) feature is an optional provision, you will want to carefully weigh the advantages and disadvantages of adding this feature. Some of the considerations are:

- Is the Roth 401(k) appropriate for your company's workforce?
- How will the Roth 401(k) be communicated to participants?
- How will participants receive guidance on whether to make regular 401(k) deferrals or Roth 401(k) deferrals, or both?
- Will payroll systems, payroll providers and others be able to accommodate Roth 401(k) contributions?
- How and when will the plan be amended to reflect the Roth 401(k) provisions?
- If your plan uses automatic enrollment, should you require elective deferrals to be made on a Roth or regular basis?
- If your plan provisions require automatic cash-out of terminated participant account balances that are less than \$5,000, will it be necessary to provide for both regular and Roth IRA rollover accounts?

Implementation

If your company decides to offer the Roth 401(k) option, the implementation steps are:

1. **Contact your Schwab representative** – Discuss considerations for your plan and determine the Roth 401(k) activation date.
2. **Payroll systems update** – Update payroll systems and contribution file layout.
3. **Plan amendment** – We can provide your company with the Plan Amendment (if using a Schwab-provided plan document).
4. **Communication to participants** – We can help you develop a communication plan to educate your employees about the new plan feature (tactics may include announcements on schwabplan.com, statement messaging, sample e-mail templates and/or print communications).
5. **Participant enrollment** – Participants make Roth 401(k) deferral elections using schwabplan.com or our call center.

Questions?

To learn more about Roth 401(k), please contact your Schwab representative, call 1-877-456-0777, or visit scrs.schwab.com.

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