

Roth 401(k) & Roth 403(b) Contributions

Making sense of it all

WHAT IS IT?

Effective January 1, 2006, employers could begin to offer designated Roth contributions in their 401(k) or 403(b) plans. This feature was recently made permanent by the Pension Protection Act of 2006. Once offered in the plan, a participant may elect to contribute all or a portion of their elective salary deferrals as Roth contributions. Designated Roth contributions are “after tax,” meaning the salary is taxed as regular income before being deferred to the participant’s account. Upon qualified distribution, designated Roth contributions and associated earnings are free from taxation*. This differs from traditional salary deferrals which are made on a pretax basis and any investment earnings accumulate tax deferred, with taxes generally payable upon distribution. Plans cannot be set up to offer only Roth deferrals, pre-tax deferrals must also be offered.

KEY FEATURES

- Opportunity to offer a competitive retirement plan to employees
- Allows employees to save for their retirement with after-tax and/or pre-tax contributions
- Qualified distributions from the Roth contribution accounts are non-taxable to the participant*
- Available to employees at any income level. There are no modified adjusted gross income limits like there are for a Roth IRA

- Employee Roth salary deferrals and associated earnings are 100% vested immediately
- Roth contributions may be made available for loans
- All or a portion of the age 50+ catch-up contributions may be designated as Roth deferrals
- Roth contributions from the plan may be rolled over to a Roth IRA and potentially may delay Required Minimum Distributions (RMD) for employees or their beneficiaries.

	Traditional 401(k)	Roth 401(k)
Salary Deferral Contributions	Pre-Tax	After-Tax
Earnings	Tax-Deferred	Tax-Free*
Withdrawals	Taxable	Tax-Free*
Rollover Ability	Traditional 401(k) or IRA	Roth 401(k) or Roth IRA
Vesting	100% immediate	100% immediate

HOW IT WORKS

Employers must amend their plan documents to add the designated Roth salary deferral feature to their plan. The designated Roth contributions and gain/losses must be tracked separately from the pre-tax deferral contributions, and the employer’s payroll system will need to establish a designated Roth contribution deduction code and appropriate withholding and Form W-2 reporting. Total



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contributions to the plan (both Roth and traditional pre-tax deferrals) cannot exceed the IRS annual limits, or the plan's limit if less. The participant will need to complete a new deferral election if they choose to make designated Roth deferrals. Roth Contributions to the plan are considered an irrevocable elective deferral (i.e., no "recharacterizing" like there is with a Roth IRA).

Taxation of Distributions

The Final Regulations of April 30, 2007 indicate that designated Roth contributions will be treated as elective deferrals and therefore, will only be eligible for distribution upon a participant's 1) termination of employment, 2) death, 3) disability, 4) attainment of age 59½ (if permitted under the provisions of the plan), or 5) a financial hardship. However, distributions under these circumstances may be taxable.

To be treated as a "tax free" or "qualified" distribution, the distribution must be made at least 5 years after the first designated Roth contribution was made to the plan AND the distribution must be made after the participant's 1) attainment of age 59½, 2) death, or 3) disability. Unlike a Roth IRA, a distribution of designated Roth contributions from a retirement plan to finance the purchase of a first home is not available and will not be treated as a "qualified" distribution.

Please note, if a participant receives only a partial distribution from the Roth account in their plan, the income from the distribution will be distributed on a pro-rata basis. The "ordering" rules relative to Roth IRA distributions will not apply.

Example:

Non-qualified distribution of \$5,000.

Account balance is \$10,000 and consists of \$8,000 of Roth deferrals (basis) and \$2,000 of earnings.

Non-taxable portion of distribution: \$4,000

Taxable portion of distribution: \$1,000 [$\$5,000 \times \$8,000/\$10,000 = \$4,000$]

Five Year Period

Under the Final Regulations, the five-year period of participation begins on the first day of the employee's taxable year for which the employee first made the designated Roth contribution to the plan and ends at the completion of five (5) consecutive taxable years. This five-year period is plan specific, so if the individual participates in two separate qualified retirement plans the five-year period would be based on each plan. In the case of a direct rollover of designated Roth contributions from one qualified retirement plan to another, the five-year period is the earlier of the two plan's five-year periods.

Please note, the five-year clock for Roth IRAs is totally separate and distinct from the five-year clock for designated Roth contributions in the qualified retirement plan. Consequently, if an individual has never before made a Roth IRA contribution, a direct rollover will start the Roth IRA five-year clock. The



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designated five-year clock from the qualified retirement plan does not carry over.

Rollovers

Rollovers of Roth contributions are permitted to a designated Roth account in another qualified retirement plan (if the plan allows for this provision) or to a Roth IRA, even if the individual's adjusted gross income would otherwise preclude them from establishing or funding a Roth IRA. The entire amount of the qualified Roth account rolled over to a Roth IRA is treated as basis in the Roth IRA. A rollover may not be made from a Roth IRA to a Roth 401(k) or Roth 403(b) plan.

An individual may make a direct rollover (plan to plan) or a 60-day rollover of an eligible distribution from the Roth contributions in the plan. In the case of a 60-day rollover, the Proposed Regulations only allow an individual to rollover the taxable portion of their Roth contributions from the plan.

REPORTING, RECORDKEEPING & NOTICE REQUIREMENTS

In the case of direct rollovers, the transferring plan is required to provide the receiving plan with a statement indicating either the first year of the five-year period and the portion of the distribution attributable to basis, or that the distribution is a qualified distribution. For distributions made directly to an employee, the transferring plan is required to provide the employee this same information upon request.

WHAT'S NEXT?

Contact your RBC Wealth Management™ Financial Consultant to learn more about adding a Roth salary deferral feature to your plan.

**if made after 5 years following the first Roth 401(k) contribution and due to death, disability or attainment of age 59½.*

This summary is designed to provide an "overview" of the Roth 401(k) regulations, and is not intended to be comprehensive. It is designed for informational purposes only, based on RBC Wealth Management's current understanding of applicable tax laws and/or IRS guidance in effect at the time of publication. Additional guidance from the IRS will be required.

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ROTH DEFERRALS VS. TRADITIONAL DEFERRALS EXAMPLE

	Tax Rate	Traditional 401(k)	Roth 401(k)	Roth 401(k) Advantage (Disadvantage)
Contribution during working years	25%	\$4,000	\$3,000	
Investment Estimated Expected Return Rate	8%			
Account Value (pre-tax) in year:	30	\$489,383	\$367,038	
Account Value (after-tax) if tax rate is:	25%	\$367,038	\$367,038	0%
Account Value (after-tax) if tax rate decreases to:	15%	\$415,976	\$367,038	-13%
Account Value (after-tax) if tax rate decreases to:	20%	\$391,507	\$367,038	-7%
Account Value (after-tax) if tax rate increases to:	30%	\$342,568	\$367,038	7%
Account Value (after-tax) if tax rate increases to:	35%	\$318,099	\$367,038	13%

This is a hypothetical example and does not assume the effect of fees, commissions, tax rates, or changes in interest rates or the rate of inflation. The information is not intended to predict or guarantee the actual results of any investment product or strategy. This data was obtained from sources deemed to be reliable, but no warranty regarding the accuracy of any such information is made. Before making any financial planning decisions relating to your unique financial situation, you should obtain tax, legal and accounting advice from qualified professionals.



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