Qualified Roth Contribution Program

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.[1]

In a qualified Roth contribution program, a participant can choose to have all or part of his elective deferrals and, if the plan allows, employer contributions, 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 regular, pre-tax portions of a plan and for those made to the after-tax, 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, elective deferral contributions to a designated Roth account are included in the Actual Deferral Percentage (ADP) test.

Contributions

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

- **Dollar limitation:** For 2023, a maximum of $22,500 may be contributed. Those who are age 50 and older may make additional contributions of $7,500. 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:** If the plan allows, employees may designate employer contributions as Roth contributions. Otherwise, employer contributions will be credited only to the regular, pre-tax portion of a plan.

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

- **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.

- **First-time homebuyer expenses:** In a regular Roth IRA, a qualified distribution may be made to pay for first-time homebuyer expenses, up to a maximum of $10,000. This provision does not apply to distributions from a designated Roth account.

- **Rollovers to designated Roth accounts:** Distributions from the regular, pre-tax portion of a qualified plan may be rolled-over into a designated Roth account. The individual (either the participant or a 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 (RMD):** For tax years *before* 2024, amounts in a designated Roth account are subject to the RMD rules applicable to plan participants when they reach age 73.[1] Beginning in 2024, however, one section of the SECURE 2.0 Act of 2022 eliminates this requirement for RMDs during the lifetime of the account owner. This change does *not apply* to taxpayers who are required to take an RMD in 2023, but who elect to take it in 2024.

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.

- **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.

[1] Under the SECURE 2.0 Act of 2022, the age to begin RMDs increases to (1) age 73 for those who turn 72 after 2022 and age 73 before 2033; and (2) to age 75 for those who turn 74 after 2032. Previously age 72 was the mandated age to begin RMDs.

Other Notable SECURE Act 2.0 of 2022 Changes

- Beginning in 2024, plan participants with compensation in excess of $145,000 in the prior year *must* have any catch-up contributions designated as Roth (after-tax) contributions.
- Beginning in 2025, plan participants who are ages 60, 61, 62, or 63 will be able to contribute an increased catch-up amount to their retirement plan.

Seek Professional Guidance

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

Disclosure Notice

The information that follows is intended to serve as a basis for further discussion with your financial, legal, tax and/or accounting advisors. It is not a substitute for competent advice from these advisors. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney. The application of other concepts may require the guidance of a tax or accounting advisor. The company or companies listed below are not authorized to practice law or to provide legal, tax, or accounting advice.

Although great effort has been taken to provide accurate data and explanations, and while the sources are deemed reliable, the information that follows should not be relied upon for preparing tax returns or making investment decisions. This information has neither been audited by nor verified by the company, or companies, listed below and is therefore not guaranteed by them as to its accuracy.

If a numerical analysis is shown, the results are neither guarantees nor projections, and actual results may differ significantly. Any assumptions as to interest rates, rates of return, inflation, or other values are hypothetical and for illustrative purposes only. Rates of return shown are not indicative of any particular investment, and will vary over time. Any reference to past performance is not indicative of future results and should not be taken as a guaranteed projection of actual returns from any recommended investment.