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NEW ROTH CONTRIBUTIONS FEATURE FOR GOVERNMENTAL 457(B) PLANS

By: NAGDCA Publications Committee and Executive Board

History

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 authorized plan sponsors to include Roth contribution provisions in their 401(k) and 403(b) plans beginning January 1, 2006. Although scheduled to expire at the end of 2010, these Roth contributions were made permanent by the Pension Protection Act of 2006. The Small Business Jobs Act of 2010 expanded the availability of Roth contribution provisions to governmental 457(b) deferred

compensation plans effective January 1, 2011. Because this is a newly enacted law, additional rules and guidelines may be issued that may affect the content of this article.

What are Designated Roth Contributions?

Designated Roth contributions (Roth contributions) are also deducted from pay but are done so on an after-tax basis, and therefore do not reduce gross taxable income.

Feature	Traditional 457(b)	Roth 457(b)
Payroll Deduction	Yes	Yes
Contributions Reduce Taxable Income	Yes	No
2011 Contribution Limits	\$16,500 (\$22,000 if age 50 or over, \$33,000 for Special Catch Up). Total contributions are combined between pre-tax and Roth contributions	
Investment Growth	Accumulates tax-free	Accumulates tax-free
Federal Tax on Distributions	Taxable income	Contributions tax-free, earnings tax-free if a qualified distribution

The tax free treatment of earnings in qualified distributions is the primary reason participants may find Roth contributions attractive. Plans may allow participants to allocate their contributions between pre-tax and Roth. For example, a participant could split a 15% total contribution by putting 9% in pre-tax and 6% in Roth contributions up to the applicable dollar limit. Generally, participants may change how they split their contributions on a prospective basis, but once a Roth contribution is made, it cannot be re-characterized into a pre-tax deferral. Roth contributions and earnings must be separately accounted for within the plan. The Roth account information is listed on participant statements and other reports as a separate item (similar to the treatment of rollover amounts) but included in participant account totals. The Roth account only holds Roth contributions and the earnings generated by those contributions. It may not accept matching contributions, forfeitures or earnings generated from other accounts. Roth contributions can be included in a matching formula but the actual matching contributions cannot be deposited in the Roth account. After-tax contributions under a plan's Roth feature have no affect on the participant's ability to make a Roth IRA contribution and vice versa.

Plan Distributions Rules Still Apply

Generally, a participant must be separated from service to receive a distribution, and it is important not to confuse the definition of a qualified Roth distribution with the plan's rules governing availability of distributions such as requiring separation of service or attainment of age 70½. In other words, just because a distribution would be qualified does not mean the participant is eligible to receive a distribution at that time. A 457(b) plan may not allow in-service distributions at age 59½, which is frequently a distributable event for 401(k) and 403(b) plans.

Required Minimum Distribution (RMD) rules apply to both pre-tax contributions and Roth assets but the plan may allow participants to

choose to take distributions from either or both sources. The plan must specify the procedures and determine the participant's flexibility in choosing the sources for distributions including partial lump sums, installment distributions and unforeseeable emergency withdrawals, loans, Retirement Service Credit and Public Safety Officer Insurance Payments.

What is a Qualified Distribution?

A qualified distribution from a Roth account must meet two conditions. First, five years need to have passed since January 1 of the year in which the first Roth contribution was made. Depending on what the Plan allows for, the first Roth contribution could be a Roth contribution from pay, a rollover of Roth funds from another plan that offers a Roth feature, or an In-Plan Roth Rollover. For example, if the first Roth contribution was made on July 25, 2011, the first tax-year would start on January 1, 2011, and the five-year requirement would be met after December 31, 2015.

The second condition requires that the distribution be made on or after age 59½ or due to death or disability. If both conditions are met, the distribution is a qualified distribution and the earnings are income tax free. Distributions taken before these two requirements are met are non-qualified and the earnings are subject to income tax. Amounts paid to a beneficiary or an alternate payee under a qualified domestic relations order (QDRO) retains the same tax characterization as if the participant had received the distribution.

How are Distributions that are not Qualified Taxed?

If a distribution is not a qualified distribution, the portion of the distribution attributed to Roth contributions, termed 'basis' by the IRS, is not taxable since it was taxed at the time it was contributed to the plan. The earnings portion (if any) is taxable. The allocation between non-taxable return of contributions (basis) and



taxable earnings is determined on a pro-rata basis when distributed from the plan. The IRS states the basis portion of the distribution is determined by multiplying the amount of the nonqualified distribution by the ratio of Roth contributions to the total Roth account balance. For example, if a nonqualified distribution of \$5,000 is made from an employee's Roth account when the account consists of \$9,400 of Roth contributions and \$600 of income (earnings), the distribution consists of \$4,700 of Roth contributions (that are not includible in the employee's gross income) and \$300 of earnings (that are includible in the employee's gross income).

Can a Roth Account be Rolled Over?

Participants eligible to take a distribution may be able to roll a Roth account to another plan that offers Roth contributions or to a Roth IRA. In most cases, participants would be eligible to take a distribution after separation of service. Although unlikely, distribution of Small Inactive accounts and distributions to certain employees on active military duty may also be eligible for rollover to another plan.

Unforeseeable Emergency withdrawals, corrective distributions, RMDs, deemed distributions due to participant loan defaults and installment payments of ten years or more would not be eligible for rollover.

Rollovers to other employer plans that offer Roth accounts should be made directly. Indirect rollovers of any taxable portions of a distribution may be made to employer plans but is impractical and beyond the scope of this article.

If a rollover distribution that is not qualified is directly rolled over to another plan, the distributing Plan will supply tax information and the year of the first Roth contribution, allowing the receiving plan to give credit for any years already earned toward meeting the five-year holding period. Due to premature distribution rules that differ from 457(b) rollovers, rollovers from Roth 401(k) and 403(b) plans that have not met the five-year holding period requirement may require separate accounting until the requirements are met to be qualified. If the participant has already met the five-year requirement in the receiving plan, the funds

rolled in would also be considered qualified for purposes of the five-year rule. Qualified distributions that are directly rolled over are reported as qualified distributions to the receiving plan and do not have to “age” for another five years.

Rollovers can also be made to a Roth IRA. The Roth IRA does not, however, have the ability to use the first year that Roth contributions were made under the employer plan to begin the five-year holding period to determine a qualified distribution from the Roth IRA. If this is the first Roth IRA for the participant, the holding period

starts in the tax year the rollover is made to the Roth IRA. On the other hand, if the rollover is made to an existing Roth IRA or the participant has another Roth IRA, the Roth IRA’s holding period begins in the year the first Roth contribution was made to this or any other Roth IRA owned by the participant. Both direct and indirect rollovers to Roth IRAs are allowable. Qualifying distributions and both the taxable and tax-free portions of distributions that are not qualified may be rolled over.

Individual Roth IRAs cannot be rolled into a Roth account under an employer plan.

Comparing Roth Contributions and Pre-tax Deferrals

Roth 457(b) Advantages	Traditional 457(b) Advantages
<p>The potential for tax-free distributions of earnings. Income tax planning is generally more effective when there is a choice between funds that are taxable and those that are not. Even in retirement, income taxes can be significant since pensions, Social Security and other types of income may be subject to federal income taxation. Income tax credits and deductions as well as some governmental benefits may be reduced if your adjusted gross income is too high. Having sources to draw upon that are not subject to income tax could be very helpful. Some participants may find the availability of tax free retirement funds useful in estate planning as well.</p>	<p>Traditional 457(b) contributions reduce current taxable income. There are very few tax deductions available to most taxpayers and many deductions, credits and exemptions may be reduced based on adjusted gross income. For some participants, the income tax savings is an important part of making plan contributions affordable. Although pre-tax contributions will result in taxable distributions in the future, careful planning may limit the impact of those taxes. Some states also provide tax exemptions for retirement plan distributions. Thus, pre-tax deferrals could provide a current tax benefit that may not be heavily taxed in retirement.</p>



Comparing Roth Contributions and Roth IRAs

Feature	Roth 457(b)	Roth IRA
Contribution Limits	\$16,500 (\$22,000 if age 50 or over, \$33,000 for Special Catch Up)	\$5,000 (\$6,000 if age 50 or over)
Income Limits to Contribute	No	Yes
Easy Payroll Deductions	Yes	Sometimes
Investment Options	Determined by plan	Usually very broad
Loan Availability	Determined by plan	No
Accessibility	Determined by plan distribution rules (usually termination or age 70½)	Not limited
Non-qualified distributions	Taxed on a pro-rata basis	Tax free basis distributed first
Premature distribution penalty taxes may apply	No	Yes
First time homebuyer exception available for qualified distributions	No	Yes
Participant subject to lifetime RMDs	Yes *	No. RMDs apply to beneficiaries
Costs	May be lower in larger sized plans	Varies, often higher

* Assets accumulated in a Roth 457(b) account could be rolled over to a Roth IRA prior to age 70½ to avoid this potential disadvantage.

There are a number of other differences between Roth IRAs and Roth 457(b) accounts which are beyond the scope of this article. Each individual will have to decide which is best for him or her or whether both types of accounts are the best option.

How the Communications and Education Process is Different

Previously, plan communications have focused on the value of a tax deduction received today and paying it back at lower rates in the future. The Roth feature's selling points are more about coordinated retirement planning and avoidance of future taxes. 401(k) and 403(b) plans offering Roth contributions, which have a few years of history, have seen gradually increasing participation especially among new employees and younger employees with low to middle incomes. These employees are best approached using multiple communications channels and are more likely to use Web-based modeling tools.

Decision Points

Deciding to designate deferrals as Roth contributions can be complicated since many factors are involved. One of the primary factors in making this decision is the expected difference in income tax rates today versus what will apply at retirement. For many, tax brackets are expected to be lower when retired than when working. If the tax bracket will be lower at retirement, pre-tax deferrals may be advantageous because taxes would be saved at a high rate and paid back at a low rate. However, federal and state tax rates can and do change. Personal situations may also change, that could result in higher income and tax rates at retirement.

Other important factors to consider are anticipated rates of return and how long these returns will compound until distributions begin. The higher the expected rate of return and the longer until retirement, the more attractive a Roth contribution could be. A relatively small tax cost paid today could forgo paying taxes on

a larger balance in the future. Conversely, Roth contributions may be less attractive for those close to retirement who are currently in a high tax bracket and expect to be in a lower tax bracket at retirement. It is important that a tax advisor is consulted to determine the affect making Roth contributions would have on one's tax and financial situation.

What Employers Must do

Employers are not required to adopt Roth contribution provisions which are completely optional. Interested employers will need to amend all plan documents and make changes to administrative and payroll processes prior to accepting Roth contributions. Employee communications and forms will require extensive re-design since Roth contributions and In-Plan Rollovers have new income tax and planning implications for participants. According to a 2010 retirement survey by Hewitt, 29% of mid to large employers currently offer a Roth feature. Another 25% said they are very or somewhat likely to add the feature in 2010.

IN-PLAN ROLLOVERS / CONVERSIONS

What Is An In-Plan Roth Rollover?

This is a new law for all employer sponsored retirement plans. In the past, the only way a participant could convert a 457(b) plan (or any qualified plan) to a Roth vehicle was to roll it over to a Roth IRA. The newly enacted In-Plan Rollover allows for such a conversion without having to take an actual distribution from a plan. It is available only to plans that have a Roth contribution feature in place. No income limits apply.

Only the plan participant, a beneficiary who is a surviving spouse or a spousal alternate payee is eligible to execute an In-Plan rollover. An in-plan conversion must qualify under the rules of an Eligible Rollover Distribution (ERD). ERDs

include distributions due to separation of service, attainment of age 70½, receipt of a Small Inactive Account Distribution or a distribution under the Heroes Earnings Assistance and Relief Tax (HEART) Act. Amounts held in a pre-tax rollover account are also eligible. Distributions that are RMDs, unforeseeable emergency withdrawals, periodic payments of 10 years or more or corrective distributions are not eligible.

The rollover can be a direct rollover or an indirect rollover. With a direct rollover, funds are not actually distributed but are transferred to the rollover account internally. An indirect rollover is also possible where funds are distributed to a participant but rolled back into the plan within 60 days of receipt. The indirect rollover is not usually the preferred method since the plan is required to withhold 20% for federal income taxes on the distribution when paid to the participant.

The amount transferred to an In-Plan Rollover is subject to ordinary income taxes in the year of the rollover but is not subject to mandatory federal withholding. It is very important that anyone contemplating this transaction fully understand the impact this will have on their income taxes including estimated tax payments. Under federal law, once an In-Plan Roth Rollover is processed, it is irrevocable and cannot be reversed. Amounts rolled over grow tax-deferred and when a distribution is qualified, it is not subject to federal or most state's income taxes similar to a Roth contribution account.

How are In-Plan Roth Rollovers Shown in an Account?

The amounts designated as In-Plan Roth rollover contributions are separately accounted for within the plan, as required by law. Although separately recorded, they would normally be included in plan statements and are considered part of the participant's plan benefit. In the case of multiple In-Plan Rollovers, each rollover may need to be separately accounted for if they are from different type of plans. For example, a

Roth rollover from a 401(k) or 403(b) might be subject to the 10% penalty if the participant takes a nonqualified distribution. Nonqualified distributions of rollover dollars from the Roth 457(b) accounts would not be subject to such a penalty.

How Much Can be Rolled Over?

Full and partial In-Plan Rollovers are allowed. Outstanding loan balances can also be included in the rollover but the advantages and disadvantages of allowing this should be carefully considered.

What is a Qualified Distribution?

The definition is the same as for Roth contributions. Even though a distribution from the In-Plan rollover may be allowed, it would still need to be qualified to be received tax-free. RMDs apply to both pre-tax and Roth rollover subaccounts but the plan can allow the participant to choose to take the distribution from either or both sources. The plan may also allow participants to choose the sources of funds for partial lump sum and installment distributions.

How are nonqualified distributions taxed?

The rules are the same as for Roth contributions but could be impacted by the Special Recapture tax.

What is the Special Recapture Tax?

If the source of funds used for an In-Plan Roth Rollover is from a pre-tax rollover originally from another retirement plan that was not a section 457(b) plan, a 10% Special Recapture Tax may apply if distributions are made from the In-Plan Rollover Account before the end of the fifth tax year after it was processed. This is a separate calculation from the determination of the qualified status of a distribution. The ordering rules for distributions made prior to the fifth year from plans that include In-Plan Rollovers are very complex. This tax may apply

even if the distribution would be qualified for other purposes. This tax will not apply if the distribution is made after age 59½ or due to death or disability. It will also not apply if the funds are rolled over to another designated Roth account or Roth IRA. If more than one conversion is done, each conversion will also have its own five year requirement.

Distributions from multiple In-plan Rollovers are considered to come from the oldest rollovers first (First In First Out).

Advantages of the In-Plan Roth Rollover

The advantages are the same as for Roth contributions but would likely involve larger single amounts.

Disadvantages of the In-Plan Roth Rollover

These are also the same as Roth contributions but dealing with larger single amounts. Although keeping amounts in the pre-tax portion of the account may result in taxes being paid in the future, planning may be used to limit the impact of those taxes. A large rollover could trigger taxation at higher tax brackets and lose tax and other important benefits such as determination of financial aid eligibility. The taxpayer would need to have funds available to pay the applicable taxes generated by the In-Plan Rollover including estimated tax payments. This is an important consideration especially if the source of the tax money also creates an additional tax liability.

Comparing In-Plan Roth Rollovers and Roth IRA Rollovers

The comparisons are similar to those made when reviewing Roth 457(b) contributions and Roth IRAs but are likely, but not necessarily, to involve larger sums of money and later in one's working career.

Feature	In-Plan Rollover	Roth IRA Rollover
May re-characterize (reverse rollover)	No	Yes, by taxpayer's tax return filing date plus extensions
Special recapture tax	May apply in certain circumstances	May apply to any distribution taken within five years of conversion

What Employers Must Do

It is very important that participants are encouraged to consult with their tax advisor to determine the affect an In-Plan Roth Rollover would have on their tax and financial situation.

If the employer wishes to enable In-Plan Roth Rollovers, the plan document must also include provisions allowing Roth contributions effective no later than when they wish to allow In-Plan Rollovers. The 402(f) notice will also need to include language that explains In-Plan Rollovers. Model language is available in IRS Notice 2010-84 that could be used for this purpose. Employers should start discussions early with administrative service providers to ensure that they can handle all the intricacies of these new accounts since vendors have had little opportunity to plan for the required changes to recordkeeping processes.

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