

Roth 401(k) Contributions and the Five-Year Clock

Our ERISA consultants on the Columbia Management Resource Desk regularly receive calls from financial advisors who have specific questions on establishing Roth accounts in 401(k) plans—or Roth 401(k) contributions.

Participants in 401(k) or 403(b) plans with designated Roth contribution features may allocate some or all of their elective contributions under the plan as Roth 401(k) contributions.

Roth 401(k) contributions must be

- specifically designated as Roth contributions;
- made to separate accounts and separately tracked within the plan;
- made on an after-tax basis; and
- limited, to where the combined total of pre-tax salary deferrals and Roth after-tax contributions does not exceed the annual limit (i.e., \$16,500 for participants under age 50, and \$22,000 for participants age 50 or greater for 2009).

The appeal of Roth 401(k) contributions is the potential for tax free distributions and, unlike for Roth IRA contribution eligibility, there are no modified adjusted gross income limits on higher earners to establish this Roth pool of assets. Distributions of Roth 401(k) contributions can be taken tax and penalty free if the participant meets certain conditions for a “qualifying distribution.” A qualifying distribution is one that is made after a five-taxable-year period of participation, **and** the participant has attained age 59 ½, has become disabled, or in the case of a beneficiary, following the participant’s death.

Through our relationship with the Columbia Management Learning Center, we regularly guide Columbia Management’s financial advisor partners through the rules and regulations affecting 401(k) plans, including those that apply to Roth 401(k) contributions. A recent call with a Robert W Baird advisor in Maryland is representative of a common question on this subject. The advisor queried: When does the five-year clock begin for purposes of determining a qualifying distribution of Roth 401(k) contributions?

Highlights of Recommendations

The five-year clock begins on the first day of the participant’s taxable year in which he or she first made designated Roth contributions to the plan. If the contribution is a rollover of designated Roth contributions from another plan, the starting of the five-year clock depends on whether the rollover is direct or indirect.

If the participant completes a direct rollover from a designated Roth account under another plan, the five-year period is deemed to have begun on the first day of the taxable year that the employee made Roth 401(k) contributions *to the other plan*. In contrast, an indirect rollover contribution restarts the five-year clock under the *receiving* plan for a participant who has made no prior Roth 401(k) contributions to that plan.

Conclusion

Since the five-year clock for determining a tax-free, qualifying distribution of Roth 401(k) contributions begins on the first day of the participant's taxable year in which he or she first made designated Roth contributions to the plan, it may be wise for a participant—if he or she has the option—to designate even \$1 of elective contributions as a Roth 401(k) contribution in order to start the ticking of the five-year clock. And if a participant is rolling over Roth 401(k) contributions—a direct rollover is the only way to avoid restarting the five-year period.