



CASE OF THE WEEK

After-Tax Contributions in 401(k) Plans

Our ERISA consultants on the Columbia Management Learning Center Resource Desk regularly receive calls from financial advisors who have questions about 401(k) plans.

Through our relationship with the Columbia Management Learning Center (CMLC), in addition to other topics, we routinely guide Columbia Management's financial advisor partners through the IRS and/or Department of Labor rules and regulations that govern the applicable limits and testing requirements associated with contributions to 401(k) plans.

A recent call with an Ameriprise advisor in Ohio is representative of a common 401(k) plan contribution scenario. The advisor's client wants to make after-tax contributions to his plan that could potentially be converted to a Roth IRA at some point. The advisor asked:

What are the considerations for a 401(k) plan participant who wants to "max out" his/her after-tax contributions in the plan?

Summary of Recommendations

- In order for a participant to make after-tax contributions to his 401(k) plan, the plan document must specifically allow for this type of contribution. Using our "plan snapshot" library of employer plan documents, the CMLC consultant was able to confirm that the 401(k) plan in question does permit after-tax contributions.
- Additional considerations when making after-tax contributions include any plan specified contribution limits; the actual contribution percentage (ACP) test; and the IRC Sec. 415 annual additions test.
- Despite having a plan imposed contribution limit of 50 percent of annual compensation, the advisor determined his client could maximize his pre-tax contributions and still make a large after-tax contribution as well.
- After-tax contributions are subject to the ACP test—a special 401(k) test that compares the rate of matching and after-tax contributions made by those in upper management (a.k.a., highly compensated employees) to the rate made by rank-and-file employees (a.k.a., nonhighly compensated employees) to ensure the contributions are considered nondiscriminatory. If the plan fails the ACP test, a typical corrective method is a refund of after-tax contributions to upper management employees.
- Each plan participant has an annual total plan contribution limit of 100 percent of compensation up to \$49,000 under IRC Sec. 415 (a.k.a., the annual additions limit).¹ All contributions to the 401(k) (e.g., salary deferrals, profit sharing, matching, qualified Roth and after-tax) are included in a participant's annual additions. If a participant

¹ Participants age 50 and older may make additional salary deferrals of up to \$5,500, which raises their annual additions limit to \$54,500 for 2010.

exceeds his annual additions limit, a typical corrective method is a refund of contributions.

- In general, a 401(k) plan participant can convert his after-tax account balance to a Roth IRA while working as long as 1) the plan allows for in-service distributions; 2) the after-tax contributions and their earnings have been segregated from the other contribution types in a separate account;² and 3) the participant follows the standard conversion rules.

Conclusion

Over half (54 percent) of 401(k) plans today offer participants the ability to make after-tax contributions.³ While this may be viewed as a benefit from many perspectives, there are several important considerations of which plan participants must be aware. With the expert guidance of the Columbia Management Learning Center, advisors can confidently assist their clients in understanding the limiting factors associated with 401(k) plan after-tax contributions.

² Notice 87-13 and Notice 2009-75

³ Profit Sharing Council of America, 2009