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ADAMS AND REESE /
LANGE SIMPSON LLP
2100 Third Avenue North, Suite 1100
Birmingham, AL 35203
Tel: 205-250-5000
Fax: 205-250-5034

ERISA AND EMPLOYEE BENEFITS PRACTICE TEAM

Duncan B. Blair, Attorney
(205) 250-5052
duncan.blair@arlaw.com
Nancy D. Bolyard, Attorney
(205) 250-5067
nancy.bolyard@arlaw.com
Nicole Eichberger, Attorney
(504) 585-0359
eichbergerna@arlaw.com
Deborah B. Hembree, Attorney
(251) 433-3234
deborah.hembree@arlaw.com
Frances King Quick, Attorney
(205) 250-5081
frances.quick@arlaw.com
JoAnne Ray, Attorney
(713) 308-0149
joanne.ray@arlaw.com
Robert C. Schmidt, Attorney
(225) 336-5200
schmidtrc@arlaw.com
J. Martin Sheffield, Attorney
(205) 250-5064
martin.sheffield@arlaw.com
Diane Averitt, Legal Assistant
(205) 250-5076
diane.averitt@arlaw.com
Lauri Anders, Secretary
(225) 336-5200
anderslb@arlaw.com
Debra Carlisle, Legal Assistant
(205) 250-5933
debra.carlisle@arlaw.com

Norman Stein, Contributing Editor

www.adamsandreese.com

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TO ROTH OR NOT TO ROTH: DIFFERENCES BETWEEN TRADITIONAL AND ROTH SAVINGS VEHICLES

There was a time not too long ago when the name Roth referred to the senior senator from Delaware and not to a type of individual retirement account or 401(k) plan. In those days, contributions to IRAs and elective deferrals to 401(k) plans were generally made before tax and IRA withdrawals and 401(k) distributions were taxed on receipt.

Today, because of new types of IRAs and 401(k) plans championed by Senator Roth and now bearing his name, the world is a bit more complex. Today an eligible individual can contribute to a regular or a Roth IRA. And a 401(k) participant can make a regular or Roth elective deferral.

If you are reading this newsletter, you probably know that contributions to Roth IRAs are made after tax—no up-front deduction. Similarly, Roth elective deferrals are included in taxable income. But that's it for tax--Roth distributions are ordinarily tax-free.

An individual today can contribute $3,000 to a regular or to a Roth IRA. And a participant can elect to defer up to $12,000 to a regular 401(k) account or a Roth 401(k) account. (The next few years will see the IRA limit increase to $5,000 and the elective deferral limit increase to $15,000. An individual over 50 can also make catch-up contributions to either an IRA or 401(k) plan.)

This article will explore the significant differences between Roth and regular IRAs and 401(k) plans. It will focus on whether individuals should use the Roth feature, whether firms should retrofit existing 401(k) plans to accept Roth contributions, and whether owner-dominated small businesses without an existing 401(k) plan should adopt a Roth 401(k) plan with Roth features.

The article proceeds in four parts. The first part explains a little understood fact about Roth contributions: in most situations, a dollar contributed to a Roth savings vehicle is worth more than a dollar contributed to a regular IRA or 401(k) plan. This extra value has the effect of making the Roth contribution limits higher than the contribution limits for regular IRAs and 401(k) plans.

Part two of the article compares Roth vehicles with traditional IRAs and 401(k) plans, with an eye toward whether an individual should favor the Roth over the traditional vehicle. Part 3 looks at Roth 401(k) plans, with an eye toward whether employers should amend their plans to include a Roth option. Part 4 explains why a small, even a one-person business, might want to replace a traditional profit-sharing or money-purchase pension plan with a Roth 401(k) plan.

OUR MERGER

On January 1, 2003, Adams and Reese LLP and Lange, Simpson, Robinson & Somerville LLP merged, creating the largest law firm in Alabama, Louisiana and Mississippi. With a total number of attorneys approaching 300, the firm has offices in Birmingham, Baton Rouge, Jackson, Houston, Mobile, New Orleans and Washington DC.

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1. Roth Contribution Limits v. Traditional Contribution Limits

So is a dollar contributed to a Roth savings vehicle really more valuable than a dollar contributed to a traditional savings vehicle? The answer for most individuals is usually yes, unless your tax rate will drop significantly at the time of distribution. Why is this?

In the abstract, it is because a dollar contributed to a traditional IRA or 401(k) vehicle is a dollar with a future tax liability attached to it—it is, in a sense, less than a full dollar that is earning money in the plan, since the government has a future claim on a portion of that dollar (and on the investment income it earns). In contrast, a dollar contributed to a Roth savings vehicle is a dollar on which the government has no future claim.

Of course, the dollar contributed to the Roth vehicle requires more than a dollar of up-front cost, since you not only have to make the contribution, but also have to pay tax on the contribution. In a sense, then, the real contribution to a Roth vehicle is the contribution itself plus the tax paid on that contribution.

As a result of this reality, the contribution limits for Roth IRAs and 401(k) plans are effectively higher than the limits for regular IRAs and 401(k)—even though the nominal contribution limits are the same. (One way of thinking about this is that a $3,000 contribution to a regular IRA is $3,000, while a $3,000 contribution to a Roth IRA for someone paying tax at a 36% rate is really $4,687.50, the amount of earnings that after tax--$1,687.50--leaves the taxpayer with the $3,000 to contribute to the IRA.)

So how does this play out in terms of value at the end of day? Let's compare two 40-year-olds, one of whom contributes $3,000 to a regular IRA and one of whom contributes $3,000 to a Roth IRA. We will assume that each pays tax at a 36% rate and that the IRA will earn an average annual rate of return of 6%. At age 65, both of our contributors will have $12,876 in their IRA. But if the owner of the regular IRA takes that amount out, he will have to pay tax; at a 36% rate, the tax would be $4,635, leaving him with $8,231. In contrast, the owner of the Roth IRA can withdraw the full $12,876 and keep it.

2. Traditional v. Roth Savings Vehicles from the Participant's Point of View

Who should use a traditional IRA or 401(k) plan and who should use a Roth IRA or plan? Consider the following:

Do you earn too much to use a regular IRA?

We can start off by noting that some people eligible for Roth IRAs are not eligible for traditional IRAs. You are eligible to use a traditional IRA in two circumstances: if your employer does not sponsor a qualified plan for you (or your spouse) or if your "modified adjusted gross income" is less than a specified dollar limit, which generally speaking this year is $40,000 for unmarried people, $60,000 for people filing a joint return ($150,000 if you are subject to the income limit only because your spouse is a participant in an employer–sponsored plan). In contrast, you are eligible to make a full contribution to a Roth IRA only if you are married and have adjusted gross income up to $150,000 or if you are unmarried up to $95,000.*

Thus, if you make too much to use a regular IRA, your only choice may be a Roth IRA. Also, if you are over age 70.5, you can't make contributions to a regular IRA but you can to a Roth IRA.

On the other hand, if you don't participate in an employer plan but make more than the Roth IRA limits, your only choice is a regular IRA.

Do you want to contribute the maximum amount to an IRA or 401(k) plan?

For reasons described in the first part of this article, the Roth contribution limits are effectively higher than the limits for traditional IRAs and 401(k) plans, even though they are both nominally set at the same level.

Do you need the immediate tax savings?

For some people, a contribution to an IRA or 401(k) plan is attractive because it reduces the tax bill for the year of contribution. (Some people use the immediate tax savings to help fund their IRA.) Roth IRAs, or course, don't reduce this year's tax bill.

(Note: the normal distribution requirements apply to traditional and Roth 401(k) plans.)

Do you expect your tax rate to increase between the time of contribution and withdrawal?

If so, Roth IRAs and 401(k) plans especially make sense. As a result, younger people, who generally expect to see their incomes rise, should seriously consider Roth contributions.

Do you want to delay distribution beyond age 70.5?

In a regular IRA you must begin making withdrawals in the year following the year you attain age 70.5. In contrast, Roth IRAs do not require you to begin taking benefits at all. Thus, Roth IRAs are better vehicles for building an estate (and your heirs will receive the Roth IRA free of income tax).

3. Should Employers Roth-Retrofit Their 401(k) Plans?

A 401(k) plan is not a Roth plan unless the employer decides to make it a Roth plan. Should the employer do so? The main reason not to is cost. It will cost the employer a bit of time and a bit of money to add a Roth feature to an existing 401(k). Also, a Roth plan must maintain separate Roth accounts, so the recordkeeping is more complex. But there are two key advantages.

First, the maximum limits on elective deferrals are effectively higher for a Roth 401(k) plan than for a traditional 401(k) plan. As we explained above, a Roth elective deferral in effect includes the tax the employee pays in the year of deferral. In a traditional 401(k) plan, the employee can defer $12,000 before tax. Assuming the employee has a marginal tax rate of 36%, he can effectively increase his deferral to $18,750 in a Roth IRA (since that is the amount which will leave her with the $12,000 maximum after she has paid tax). Thus, the creation of a Roth feature to a 401(k) plan can allow valued employees to obtain significantly greater tax benefits than they could in a traditional 401(k) plan.

Second, a Roth feature can effectively increase the deferral percentage for highly compensated employees in plans subject to ADP testing. Some 401(k) plans are subject to ADP testing, a procedure which essentially limits elective deferrals (as a percentage of pay) for highly compensated employees to a multiple of the elective deferrals (as a percentage of pay) of the nonhighly compensated employees. For example, if the nonhighly compensated group of employees defers on average 4% of pay, then the highly compensated employees, as a group, can defer no more than 6% of their own pay. As we have already seen, a Roth 401(k) deferral is effectively larger than a traditional 401(k) deferral of the same nominal dollar amount. Thus, attaching a Roth option to a 401(k) plan allows highly compensated employees an indirect means of increasing contributions otherwise limited by the ADP test.

If a firm decides to add a Roth feature to its 401(k) plan, it is often necessary to educate its employees about how Roth contributions work and how they effectively result in increased contributions for individuals who are already deferring the maximum permissible amount (either because of the maximum limits on elective deferrals or because of the operation of the ADP test.) This is not always intuitively obvious to employees.

* Both type of IRAs permit reduced contributions for individuals who exceed the dollar limits by only a small amount—by less than $10,000 in the case of regular IRAs and less than $15,000 in the case of Roth IRAs. The maximum contribution is reduced pro rata over such excess. For example, a single tax payer whose adjusted gross income is $45,000 could contribute $1,500 rather than $3,000 to a regular IRA.

4. What About Roth 401(k) Plans for One-Person and Other Owner-Dominated Firms?

A few years ago it would have been hard to understand why a sole proprietor or in some cases an owner-dominated small firm would have considered sponsoring a 401(k) plan rather than simple profit-sharing. For one thing, a simple profit-sharing plan is a bit easier to administer; for another, there are fewer prohibitions on in-service distributions. And the idea of elective deferrals just doesn't mean anything to a sole proprietor without employees and often will not mean much to a small business owner with only one or two employees.

But today a 401(k) plan might be a good strategy for the owners of such businesses when the owner is already making the maximum deductible contributions to a non-401(k) defined contribution plan and would like to contribute more. A 401(k) plan facilitates larger contributions than run-of-the-mill profit-sharing and other non 401(k) plans in three ways: first, a person over 50 can make additional "catch-up" contributions to a 401(k) plan; second, a person can make Roth contributions to a 401(k) plan; third, elective deferrals do not count against the 25%--of-compensation limit on deductions to defined contribution plans Thus, if an owner of a business is already contributing $40,000 annually (the current general dollar limit) to one or more defined contribution plans, or it the owner is bumping up against the 25% limit on deductions to such plans, and would like to be able to contribute more, the owner might want to think about adding a 401(k) feature to its profit-sharing plan or to adopt a new 401(k) plan. Consultants have even given a name to one-person 401(k)s—the "solo 401(k)."

So, if the question is whether to Roth or not to Roth, the answer, like the answer to so many questions in the employee benefits area, is it depends.

NEW GUIDANCE

The Department of Health and Human Services issued final HIPAA regulations on security for electronic storage and transmission of protected health information. In general, covered entities will have until April 21, 2005 to comply with the security regulations. However, the already-final general regulations on HIPAA privacy, which go into effect on April 14th of this year, require that appropriate safeguards are in place by the earlier date. While the security measures that must be in effect this year will not be judged by the new regulations, they will require, at a minimum, the implementation of policies of computer use and transmission of protected health information; a policy ensuring that rooms and file cabinets containing such information be locked; and creating password protection for electronic files. The security regulations were published on February 20, 2003 at 68 Fed. Reg. 8334 and can be viewed or downloaded at

http://www.cms.gov/regulations/hipaa/cms0003-5/0049f-econ-ofr-2-12-03.pdf.

IRS releases 2003 edition of Employer's Tax Guide to Fringe Benefits, which provides a useful summary of the tax treatment of various types of fringe benefits. The publication can be ordered from the IRS and is accessible online at, among other places, http://benefitslink.com/IRS/pub15b_0301.pdf

IRS issues Rev. Proc. 2003-23 on direct transfer of S-Corp stock from an ESOP to an IRA. The revenue procedure says that an ESOP can make a direct transfer of S-Corporation stock to an IRA without terminating the S election if the ESOP's terms require that the S Corporation repurchase the stock immediately on distribution of the stock to an IRA; the corporation in fact does repurchase the stock immediately; and no tax attributes are allocated to the IRA. Thus, the IRA in effect can own the stock for only an instant.

TIDBITS

Surprise: Medical Costs Keep Rising. According to a survey conducted by a major consulting firm, 45% of employers report that their health care costs exceeded expectations in 2002. Health care costs are expected to rise again this coming year, perhaps by as much as 15%.

Description of President's New Retirement and Savings Account Proposals. President Bush recently proposed the creation of two new tax-advantaged savings accounts which in many ways are super Roth-IRA accounts: the Retirement Savings Account and the Lifetime Savings Account. In addition, the President suggested major changes for defined contribution plans. Congressional response has been lukewarm at best. The Congressional Research Service has published a good description of the proposal, which is available online from BenefitsLink at

http://benefitslink.com/articles/RS21451.pdf.

Congress considering new pension interest rates. The Internal Revenue Code (and Title IV of ERISA) generally uses 30-year treasury bond rates as the governing interest rate for pension purposes. The treasury rate has been at historic lows, in part because the United States stopped issuing new 30-year bonds and began a buyback program for them. This has increased pension liabilities for funding purposes and PBGC variable premium purposes, and increased lump sum payouts from defined benefit plans. Last year Congress gave defined benefit plan sponsors temporary relief for purposes of plan funding and PBGC premiums. Some trade associations are now urging Congress to act globally and permanently by substituting for the 30-year treasury rate a long-term bond index. The changes being urged would apply for all Code purposes, including calculation of lump sum values of annuities from defined benefit plans.

HIPAA sets only lowest common denominator; don't forget about state law. HIPAA gives a covered entity 60 days to act on requests to amend private health information. Some states, however, give you only 30 days and HIPAA requires the covered entity to follow more stringent state law in this situation. Indeed, state law will generally be enforceable so long as it is possible to comply with both HIPAA and the state law. Entities subject to HIPAA should be reviewing state laws to determine which, if any, state laws raise the privacy bar above where HIPAA places it.

Important HMO Preemption Case. A federal appellate decision in New York is getting a lot of attention. An HMO ruled against a doctor's treatment recommendation and itself suggested a less costly treatment. The patient died and his estate sued the HMO under state law for medical malpractice. The Second Circuit, with one judge dissenting, held that ERISA did not preempt the state-law malpractice claim against the HMO, which had acted in the role of medical provider. The case is Cicio v. Vytra Healthcare and the court's opinion can be accessed online at:

http://www.ca2.uscourts.gov:81/isysnative/RDpcT3BpbnNcT1BOXDAxLTkyNDhfb3BuLnBkZg==/01-9248_opn.pdf#xml=http://10.213.23.111:81/isysquery/irl9226/1/hilite.

Adams and Reese/Lange Simpson LLP
2100 3rd Ave. North, Suite 1100
Birmingham, AL 35203

Drop us a note…

If you have a question or would like to see a particular topic addressed, please let us know by emailing us at Debra.Carlisle@adamsandreese.com or by writing to us at:

Adams and Reese/Lange Simpson LLP
Attn. Debra Carlisle
2100 3rd Ave. North, Suite 1100
Birmingham, AL 35203

We will try to address your question or topic in a future newsletter.

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