



the new Roth 401(k)

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As the January 1, 2006, implementation date for the Roth 401(k) program nears, the Roth 401(k) is increasingly generating interest and questions. Plan sponsors, participants, TPAs, and financial representatives are eager for clear and balanced information. At John Hancock USA, we are not only ready to accept Roth 401(k) contributions on January 1, 2006, but we are ready to help you by delivering insight and knowledge. This guide is designed to help you understand and optimize the potential of the Roth 401(k) program.

## What is the Roth 401(k)?

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with answers

Beginning January 1, 2006, plan sponsors can elect to add a "qualified Roth contribution program" to their 401(k) or 403(b) plan under Section 617(a) of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001. The Roth 401(k) feature is not mandatory but if offered, all eligible plan participants will be able to contribute. A plan amendment will be required if a plan sponsor wishes to add the Roth 401(k) feature to his or her 401(k) plan.

A qualified 401(k) plan may allow participants to designate some or all of their elective salary deferrals to either a traditional 401(k) account or a Roth 401(k) account. The Roth 401(k) contribution is an after-tax elective deferral with income taxes paid up front at the participant's current tax rate. Its earnings are tax-free if distributed in a "qualified distribution." This is in contrast to the traditional 401(k) contribution where the elective deferral is tax-deferred so that both the contribution and earnings are taxed at distribution.

The Roth 401(k) is modeled on the Roth IRA account to appeal to participants who want the tax benefit of having their investment earnings grow and be distributed tax-free at retirement. The Roth 401(k) contribution and its earnings are tax-exempt provided that the distribution is a qualified distribution, i.e., occurs at least five years after the first Roth contribution and on or after the participant's attainment of age 59½, death or disability.

It's important to note that the Roth 401(k) provisions are subject to EGTRRA's sunset provision. Without a congressional extension, it will expire at the end of 2010. If this happens, we feel it is very likely that Roth 401(k) contributions in existing accounts will be allowed to remain there without adverse tax effect, but further Roth 401(k) contributions will not be allowed.

## What is the difference between a traditional 401(k), Roth 401(k) and a Roth IRA?

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	Traditional 401(k)	Roth 401(k)	Roth IRA
Contributions	Funded with pre-tax dollars	Funded with after-tax dollars	Funded with after-tax dollars
Matching Contributions	Allowed	Allowed; however, employer matching of Roth 401(k) contribution but not as an after-tax contribution. The Employer Match is treated as pre-tax contributions.	No
Forfeiture Allocation	Yes, if stated in plan document	No, it must be treated as a pre-tax employer contribution	N/A
2006 Contribution Limits	\$15,000 (\$20,000 if age 50 or older)	\$15,000 (\$20,000 if age 50 or older) If participant makes a combination of Roth 401(k) and pre-tax elective deferrals, the total amount contributed cannot exceed the contribution limit.	Subject to IRA limits \$4,000 (\$5,000 if over age 50)
Income Restrictions	No	No	Yes. The Roth IRA cannot be used if the modified adjusted gross income is over \$110,000 for single filers (\$160,000 for a married couple filing jointly)
Corrective Distributions of Excess Contributions (failure to satisfy ADP test)	If plan permits, participant may choose whether the distribution is made from the traditional 401(k) or the Roth 401(k). Distribution of the excess contributions and attributable earnings must be made on a timely basis and are both subject to tax.	If plan permits, participant may choose whether the distribution is made from the traditional 401(k) or the Roth 401(k). Excess contributions are distributed tax-free but earnings are taxable if corrective distribution is made on a timely basis.	N/A
ADP Testing Required	Yes, unless plan is safe harbor 401(k)	Yes, unless plan is safe harbor 401(k)	N/A
Investment Earnings	Tax-deferred earnings	Tax-free earnings	Tax-free earnings
Taxes	Pay taxes on contributions and earnings later Reduce current income tax	Pay taxes on contributions now Qualified withdrawals are tax-free	Pay taxes on contributions now Qualified withdrawals are tax-free
Access to Money	Can get access to money when leaving job, are disabled, die or (if plan provides) reach age 59½	Subject to the same restrictions as traditional 401(k)	Subject to Roth IRA tax rules
Tax-free Distribution	Not available	2 conditions must be met: 1) Distribution must be a "qualified distribution" – attainment of age 59½, death or being disabled AND 2) Special 5-year rule – contributions must remain in the plan for 5 years of the first Roth 401(k) contribution to receive the tax-free advantage	2 conditions must be met: 1) Distribution must be a "qualified distribution" – attainment of 59½, death, disability or is a qualified first-time home-buyer distribution AND 2) Special 5 year rule – Distribution is made after the 5-year period beginning with the first taxable year in which a contribution was made to a Roth IRA
Ordering Rules for Distributions	No ordering rules; both contributions and earnings are taxable	Awaiting IRS guidance	Distributed first from regular contributions, then from conversion contribution (on a first-in, first-out basis), then from earnings
Minimum Required Distribution	Age 70½	Age 70½; A Roth 401(k) can be rolled over to a Roth IRA where minimum distribution rules don't apply to distributions made prior to death	Minimum distribution requirements apply to distributions made after Roth IRA owner's death
Rollovers	Can be rolled over into a traditional IRA	Can be rolled over into another Roth 401(k) or a Roth IRA	Can roll over into another Roth IRA

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participants  
decide

## How do you evaluate the Roth 401(k)?

One of the biggest challenges that intermediaries and plan sponsors face will be educating participants so they can wisely choose how to allocate their traditional 401(k) and Roth 401(k) contributions. It will be critical to communicate effectively to participants so they can easily understand and evaluate the Roth 401(k) feature.

There are some general rules of thumb. The decision by the participant to designate all or part of his or her elective deferrals as Roth 401(k) or traditional 401(k) contributions will depend on the participant's current tax situation, expected tax bracket at retirement and predictions on future changes to tax laws.

A Roth 401(k) program allows participants to lock in the tax rate that they're currently paying so that both the after-tax contributions and earnings can be withdrawn tax-free at retirement. If a participant has a long time horizon until retirement, investment earnings can accumulate for many years and, if the required conditions are satisfied, withdrawn on a tax-free basis.

On the other hand, if participants expect to be in a lower tax bracket at retirement and believe that taxes will not significantly rise when they're retired, there may be no advantage in choosing Roth 401(k) contributions over traditional 401(k) contributions.

Some participants may be unwilling to give up the up-front tax breaks of traditional 401(k) contributions. Hence, participants must weigh the value of tax-free distributions at retirement over the value of reducing current tax liability.

Participants' circumstances will be different and they will need to carefully weigh the advantages of a Roth 401(k) program versus a traditional 401(k) program. To answer the question as to whom the Roth 401(k) program would appeal, we offer these general observations.

- High-income earners – For participants whose income is too high to contribute to a Roth IRA, the distribution benefits have long been enticing. The problem for this group has been that they are restricted by the Roth IRA income limits. Single

participants who have a modified adjusted gross income over \$110,000 and married couples filing jointly who have a combined modified adjusted gross income of over \$160,000 are ineligible to contribute to a tax-free Roth IRA. The good news for many in this group is that there are no income limits for Roth 401(k) contributions.

- Roth IRA investors – Investors who like the Roth IRA can now contribute \$15,000 (\$20,000 if age 50 or over), the 401(k) maximum, to a Roth 401(k). That is three to four times the 2006 Roth IRA limit of \$4,000 (\$5,000 if age 50 or over). What's more, contributing to a Roth 401(k) program should not have an impact on a participant's ability to make Roth IRA contributions if eligible.
- Young participants – For many people who are early in their careers and expect their incomes to rise, Roth 401(k) contributions may also be of considerable interest. They may find that tax-free distributions of the Roth 401(k) outweigh the current benefit of making pre-tax contributions to a traditional 401(k) account.
- Participants who expect tax rates to rise in the future – A Roth 401(k) program may be an effective hedge against rising taxes for participants at all income levels. Rather than pay higher taxes on their retirement savings in the future, these employees may benefit by paying the taxes on their Roth 401(k) contributions now.
- Estate planners – The ability to roll over a Roth 401(k) to a Roth IRA will allow high-income earners to maximize their estate assets and avoid the required minimum distributions rules that apply to distributions made prior to death. There are no requirements that withdrawals be made at age 70½ from a Roth IRA.
- Participants seeking control and flexibility in tax planning for retirement – Participants will have the flexibility to split their contributions between a traditional 401(k) account and a Roth 401(k) account and provide more options for withdrawal

at retirement. Here's how this may play out. If plan permits, during years when the income tax rate is high, retired participants can withdraw from their Roth 401(k) account and from their traditional 401(k) when the marginal tax rates are low. (Note: This will depend upon Internal Revenue Service (IRS) guidance as to whether partial withdrawals from specific money types are permitted and whether the participant's plan permits partial withdrawals.)

- Participants seeking to lower taxes on their Social Security benefits – Roth 401(k) withdrawals that

are qualified distributions would be excluded as taxable income when calculating the taxes on Social Security benefits. This may be of greatest interest to participants who are approaching, but have at least five years before retirement.

The addition of a Roth 401(k) feature may add complexity to the plan's education program but we believe the benefits of offering the Roth 401(k) feature may outweigh the challenges. Ultimately, participants gain from having more choice, flexibility and control in saving and planning for their retirement.

## Who should choose the Roth 401(k) program?

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to help  
participants  
with “what-  
if” scenarios

The following scenarios are designed to help you assist participants make informed decisions by using common examples.

Please keep in mind that participating in the Roth 401(k) program is an individual decision. Factors participants may consider before making their decision may include age, income, retirement savings, the number of years until retirement, the anticipated tax rate at retirement, and the ability to contribute to a Roth IRA outside of an employer's plan. It is also crucial for employees to fully weigh the cost of losing the current tax benefit that comes with pre-tax elective contributions against the benefit of future tax-free distributions.

Now consider the following cases. (Note: these are fictional representations of common real-life scenarios.)

**Here are three cases where it may be beneficial for a participant to make a Roth 401(k) contribution.**

### Paula Milano

**Age:** 50

**Occupation:** software manager

**Taxable income:** \$120,000

**Tax bracket:** 28%

**Filing status:** married filing jointly

**Situation:** Paula plans on working many more years and is concerned that her future tax liabilities, coupled with rising taxes, will erode the value of the assets that she and her husband will pass on to their children.

### *Does the Roth 401(k) offer advantages for Paula?*

Yes, Paula can pay taxes now when she contributes to the Roth 401(k) and not be taxed later. When Paula is retired, she can avoid the Roth 401(k) minimum required distribution rule at 70½ by rolling into a Roth IRA. This may be an estate planning strategy Paula may want to consider.

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## “what-if” scenarios – making a contribution

### Andy Lee

Age: 40

Occupation: plant foreman

Taxable income: \$51,000

Tax bracket: 25%

Filing status: single

**Situation:** Flexibility is what Andy wants most of all. When he retires he wants to be able to choose distributions from pre-tax or after-tax accounts depending on his financial needs and tax status.

#### *Does the Roth 401(k) offer advantages for Andy?*

Yes, Andy can divide his annual \$15,000 contribution into traditional and Roth 401(k) accounts. Andy can use the Roth 401(k) account as a hedge against higher taxes in the future. When he retires, if the income tax rate is high, Andy can withdraw from his Roth 401(k); if the rate decreases, or he is subject to a lower tax bracket, Andy can withdraw from his traditional 401(k) account. Andy should check whether his plan permits him to make choices on the timing of taxation of contributions or allows partial withdrawals.

### Karen Anderson

Age: 25

Occupation: associate investment analyst

Taxable income: \$28,000

Tax bracket: 15%

Filing status: single

**Situation:** Karen has recently finished graduate school and is confident that her salary will rapidly increase. When she retires, she expects to be in a much higher tax bracket.

#### *Does the Roth 401(k) offer advantages for Karen?*

Yes, because Karen expects her income to rise significantly in the future. A Roth 401(k) allows her to pay taxes now and avoid taxes on her distributions later. She has a longer time horizon until retirement so that her earnings can accumulate and be distributed tax-free.

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## “what-if” scenario – not making a contribution

**There may be a number of scenarios where it is more advantageous for a participant to make traditional 401(k) contributions. Here is just one case where a participant may choose not to make Roth 401(k) contributions.**

### Joe Barnes

Age: 55

Occupation: retail manager

Taxable income: \$60,000

Tax bracket: 25%

Filing status: married filing jointly

**Situation:** When Joe retires at age 60, he doesn't expect to be in a higher tax bracket at retirement; in fact, he expects to be in a lower tax bracket. He isn't worried that the tax rate will significantly rise.

#### *Does the Roth 401(k) offer advantages for Joe?*

It's unlikely. If Joe expects to be in a lower tax bracket due to lower retirement savings income, there is no advantage for Joe to make Roth 401(k) contributions. The only possibility is, if Joe seeks to lower taxes on his Social Security benefits; the Roth 401(k) withdrawals would be excluded as taxable income when calculating taxes from Social Security payments.

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## What happens when the plan sponsor wants to add the Roth 401(k) program to a 401(k) plan?

### The time to prepare for the Roth 401(k) is now!

1. The 401(k) plan document must be amended to explicitly allow designated Roth contributions.
2. The Summary Plan Descriptions (SPD) must be updated to explain the Roth contribution option to participants.
3. Plan sponsors must make changes to their payroll system to track pre-tax salary deferrals and after-tax Roth 401(k) contributions, withhold applicable taxes on Roth 401(k) contributions at the time of deferral and make applicable tax reporting on the W-2 form.
4. The timing and frequency of Roth 401(k) elections have to be determined.
5. A participant must irrevocably designate a Roth 401(k) contribution at the time the salary deferral election is made. Once a Roth 401(k) contribution has been designated, what has already been contributed cannot be changed back to a traditional 401(k).
6. It is required that plan sponsors maintain designated Roth contributions in separate accounts apart from all other plan contributions. They must keep track of contributions and earnings of the Roth 401(k) account until the entire account is completely distributed.

be ready  
for what's  
coming next

## John Hancock USA is ready.

- We can help you put the Roth 401(k) into place. We are in the process of developing a 'How to' guide that will be available prior to the January 1, 2006, implementation date. We have the forms, systems and procedures for tracking Roth 401(k) deferrals and earnings, and on January 1, 2006, we'll be fully prepared to accept Roth 401(k) contributions from participants.
- Additional guidance is still pending from the IRS on certain issues relating to Roth 401(k) contributions. In particular, the taxation consequences of non-qualified distributions (e.g. deemed distributions for loan defaults, hardship withdrawals) from Roth 401(k) accounts remain unclear. We will keep you informed on IRS regulations.
- We're ready to be your one central source for Roth 401(k) information. You can look to us to proactively deliver balanced information and timely updates. Making smart decisions is your job. Delivering the insight to help you make them is ours.

**Contact your John Hancock USA representative for further assistance.  
We look forward to helping you be ready.**

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