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THE ROTH 401(k) OPTION -- FROM AN EMPLOYER'S PERSPECTIVE AND AN EMPLOYEE'S PERSPECTIVE

Allen Buckley, Esq.*
Smith Moore LLP
404.962.1042
allen.buckley@smithmoorelaw.com

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This outline has three parts. The first part summarizes the law relating to Roth 401(k) plans and the proposed regulations relating to Roth 401(k) distributions. Through three calculations, the second part analyzes the Roth 401(k) option and compares it to a traditional 401(k) election, from the employee's perspective. Particularly interesting is the observation that a comparison of the anticipated retirement incremental tax bracket to the working years incremental tax bracket, alone, may not be a valid basis for a comparison. Rather, aspects of the income tax system necessitate a thorough analysis of tax implications of the two options. The third part includes historical materials, including past tax brackets indexed for inflation, a pros and cons memo for employer consideration and a sample notice to employees.

I. Rules and Considerations

- **It is up to the employer/plan sponsor to decide whether it wishes to amend its 401(k) plan to make the Roth 401(k) option available to participants**

- If the plan is amended to give the option (and IRS Notice 2005-95 allows the amendment to be executed as late as the last day of plan year to which the change applies), participants must be given the right to choose between regular pre-tax 401(k) contributions or Roth after-tax 401(k) contributions (both pre-tax and Roth contributions are subject to FICA tax upon contribution)

- A Roth 401(k) plan cannot, by its terms, force any participant to make a Roth election, and must allow an option between pre-tax contributions and Roth contributions (although not covered by the regulations, it appears that participants don't have to be allowed to split paychecks between Roth and pre-tax contributions)

- Participants must be allowed to change or revoke their election at least once per year

*Allen Buckley is a partner in the Atlanta office of Smith Moore LLP. He specializes in employee benefits, tax and corporate law. From 1987 until his license expired in 2001, he was also a Georgia Certified Public Accountant (CPA). Mr. Buckley's phone number is (404) 962-1042. His email address is allen.buckley@smithmoorelaw.com

- Unlike ordinary 401(k) contributions, Roth contributions are in included in the employee's taxable income; in the same manner as ordinary 401(k) contributions, Roth contributions are included in FICA tax income

- A distribution from a Roth 401(k) account following attainment of age 59½, death or disability will be a "qualified distribution" that is completely tax free if the distribution is received more than 5 years after the beginning of the first year of a Roth 401(k) contribution; generally, if a distribution from a Roth 401(k) account is not a qualified distribution, then earnings distributed (but not the contributions) are taxable

- **In virtually all respects other than taxation of contributions and distributions (e.g. ADP testing, hardship sourcing), a Roth 401(k) contribution is the same as a traditional pre-tax 401(k) contribution**

- The plan can be drafted to specify when an excess 401(k) contribution, a hardship distribution or an age 59½ distribution is sourced from the Roth account, or can allow a participant to choose the account from which the distribution is sourced (a hardship distribution and an excess 401(k) distribution will be tax-free to the extent of Roth contributions, but earnings will be taxable)

- A Roth election by a participant must be irrevocable, and must precede compensation withholding

- Separate accounting is required for Roth contributions

- Neither forfeitures nor matching contributions can be added to a Roth account

- Unlike Roth IRAs, the minimum distribution rules of Internal Revenue Code Section 401(a)(9) apply to Roth accounts (but, a Roth 401(k) benefit can ordinarily be rolled over to a Roth IRA for tax-free growth without minimum distributions beyond age 70½)

- Automatic enrollment can be applied to Roth 401(k) contributions (subject to state law prohibitions in general)

- Rollover can be made only to a Roth IRA or to the Roth component of another 401(k) plan

- Under proposed regulations relating to distributions:

    - The five (5) year period necessary to receive a qualified distribution begins on the first day of the year in which Roth contributions are made, and ends five (5) years later; thus, if an employee makes Roth contributions to more than one plan, more than one 5-year period could exist; however, in the event of a direct rollover from another Roth 401(k) plan, the 5 year period begins on the first day of January of the year when a contribution was first made to the prior employer's plan

- Distributions that are not qualified distributions are pro rated based on the percentage of the total account that is comprised of Roth contributions (i.e. the ratio of the Roth contributions to the total account value supplies the tax–free percentage that applies to a distribution)

- The 5-year period is not impacted by the splitting of the account pursuant to a QDRO (thus, an account could be split prior to expiration of the 5-year period, and a later distribution that meets the 5-year requirement apparently would be a qualified distribution); if a QDRO exists, or multiple death beneficiaries exist, the investment in the contract must be split (although prop. regs. don't specify how to split – presumably would do pro rata); also, once the 5-year requirement is met, a complete distribution of the account would not require a restart of the 5-year period

- For complete tax–free treatment to apply, a Roth 401(k)-to-another plan rollover must be a direct rollover, and it can only be made to a plan qualified under Section 401(a) that agrees to separately account for the Roth contributions and earnings thereon (i.e., a benefit cannot be rolled over to a 403(b) plan); similarly, a Roth 403(b)-to-another plan rollover must be a direct rollover, and it can only be made to a 403(b) plan that agrees to separately account for the Roth contributions and earnings thereon; a 60-day rollover or a direct rollover can be made to a Roth IRA from both a Roth 401(k) plan and a Roth 403(b) plan

- The distributing plan in a direct rollover to another Roth 401(k) plan must report the first year of Roth contributions to the recipient plan

- A distribution to the employee can be rolled over to a Roth IRA within 60 days of receipt, provided that a failure to roll over the entire benefit will result in income recognition of the of the earnings if the distribution is not a qualified distribution (to the extent of income), with the rollover amount being first sourced from earnings (note that there appears to be an inconsistency between the preamble and the prop. regs. in this regard but the greater specificity in the prop. regs. suggests that the rollover amount is first sourced from earnings); alternatively, the taxable amount of a distribution can be rolled to another employer's Roth 401(k) account within 60 days of receipt, in which case there is no "tacking" of the period of contributions for purposes of the 5-year requirement

- The adjusted gross income limits applicable to Roth IRA contributions don't apply to a rollover from a Roth 401(k) account

- IRC §408A (relating to Roth IRAs) requires that a 5-year period pass from the time of the initial contribution before a distribution is made in order for distributions to be completely tax–free; there is no "carryover" of the Roth 401(k) contribution period for this purpose; thus, amounts rolled over to a Roth IRA must be held for at least five (5) years in the Roth IRA in order for complete tax–free treatment to apply; however, if a Roth IRA was previously established, the 5–year period that began when the first contribution was made will apply, and a subsequent roll–in from a Roth 401(k) Plan will receive the benefit of the initial contribution date; for these purposes, a qualified distribution will give rise to full "basis," meaning a premature distribution of that amount would be tax–free, although the earnings thereon would be taxable; a nonqualified distribution would not create "basis" to the extent of the amount that would be taxable but for the rollover, but such amount would be completely tax-free once the 5-year Roth IRA time frame is met

- A distribution from a Roth IRA can't be rolled over to a Roth 401(k) account

- Amounts not eligible for rollover under the ordinary rollover rules (i.e. distributions of elective deferrals in excess of the §415 limits, corrective distribution of excess elective deferrals (under §402(g) or the ADP test) and corrective distribution of excess aggregate (ACP) contributions) are not eligible for rollover, and are not qualified distributions

- A lump-sum qualified distribution of employer securities is tax-free, and the securities take a FMV adjusted basis; in the case of a lump-sum nonqualified distribution, the ordinary rules of §402(e)(4) apply (i.e. taxable to the extent of the trust's basis in the shares (unless the employee elects income recognition), apparently not to exceed the account's earnings)

- The "universality" requirement of Code §403(b) applies to the right to make a Roth election, such that any person who is eligible to make elective §403(b) contributions must be allowed to make a Roth election

- Beginning in 2007, the plan administrator (or its agent) is required to keep records for purposes of the 5-year rule and the amount of Roth contributions made to accounts; in the event of a rollover, the plan administrator of the "rolling" plan would need to supply such information to the "rollee" plan

- Regardless of any accounting rule or method, amounts cannot be shifted to Roth accounts from other plan accounts

- If a Roth 401(k) contribution is to be distributed to satisfy §402(g), then it must be distributed by April 15th in order to avoid full income inclusion of the excess amount plus earnings thereon at subsequent distribution; gap period earnings must also be distributed; the participant must notify the plan administrator of the Roth contributions to be part of the excess contributions to be returned, provided that the employer may deem an excess amount to be composed partially or fully of Roth 401(k) contributions (to the extent such contributions exist) if elective deferrals to plans of the employer and its affiliates exceed the 402(g) limit; the means of calculating allocable income and gap period income are similar to the 401(k) regulations' method of calculating gap period income

- Dividends paid under Section 404(k) and loan default deemed distributions are not qualified distributions, regardless of the age of the participant or the number of years that Roth contributions have been made, except that reinvested dividends can later be part of a qualified distribution

- With 3 exceptions (that are effective **in** 2006), regulations or applications are applicable **after** 2006 (the 3 exceptions are the rollover rules, the Roth IRA rollover rules and the prohibition on shifting value to Roth accounts); prior to 2007, plan administrators may apply a good faith interpretation of Code §402A, and following the proposed regulations will meet that standard

II. <u>Participant Roth Election Considerations</u>

- GAO Charts [page 19] [page 20] [page 21] and David Walker article [pages 16-18] – what is coming

- In 1954, adjusted for inflation, the incremental tax rate was:

  - 34% on taxable income in excess of $57,829

  - 50% on taxable income in excess of $115,654

  - 72% on taxable income in excess of $318,056

  (See prior tax rates chart) [page 15] [pages 22-27]

- The President's Commission on Tax Reform [pages 28-29] recently recommended not replacing the current income, FICA and estate and gift tax system with a national sales tax system or a flat tax system

- Senior voters outvote young voters 4-to-1

- Prior to 1981, the accumulated debt of the U.S. never exceeded $1 Trillion; it's now approximately $9 Trillion

<u>Relatively Good Bets</u>

- Someone who reasonably expects to make a lot of money in the future, but does not make a lot of money now, would likely find a Roth election to be attractive (e.g. a medical intern)

- Someone who anticipates having a lot of annual income in retirement, such that their income level is not expected to decrease (or could increase) in retirement

- Someone who is young and is in a low tax bracket, but expects to be at least an average wage earner over his/her career

- Someone who does not currently pay any income taxes

- Sample calculations attached and tax rates [page 15] [pages 22-27]

- See attached 2005 Roth 401(k) article [pages 31-33]

Closing Question: Are Roth 401(k)s the best thing since sliced bread? Some say yes; others say no. I would say no, they are not the best thing since sliced bread. But, depending on the individual facts and future income tax rates, they could be very beneficial to many persons. It appears that only the future will provide a measure of their value. The maximum amount in issue (currently) is $15,000 or $20,000 (with catch-up) for 5 years. So, ultimately, it's not a make-or-break decision at the employer or the employee level of decision-making.

Sample Calculations
General Principles

I. Assume a net-of-tax amount of $10,000 is contributed in 2006 by an employee who is age 58, the employee is presently in a 29.5% combined federal/state incremental bracket, the employee retires and takes lump-sum distribution at age 65, and earns 10% per year, inside and outside the 401(k) plan.

	Traditional (Pre-tax)	**Roth**
Contribution	$14,184	$10,000
Income tax savings (29.5%)	(4,184)	
Net Outlay	10,000	10,000
Growth:		
Contribution	14,184	10,000
Earnings[1]	13,457	9,487
Total	27,641	19,487
Withdrawal at various combined incremental rates:		
29.5%: (27,641 x .705)	19,487	19,487
Total		
16%: (27,641 x .84)	23,218	19,487
Total		
36%: (27,641 x .64)	17,690	19,487

Note: The break-even tax rate in retirement is 29.5%. Note that this rate is exactly equal to the incremental rate applicable when earned. Most people <u>anticipate</u> being in a lower incremental income tax bracket during their retirement years.

End of analysis? …..

[1] $(14,184 \times 1.10^7) - 14,184 = 13,457$; $(10,000 \times 1.10^7) - 10,000 = 9,487$

Sample Calculations
General Principles

II. Assume $20,000 is contributed in 2006 by an employee who is age 58, the employee is presently in a 32% combined federal/state incremental bracket, the employee retires and takes lump-sum distribution at age 65, and earns 10% per year, inside and outside the 401(k) plan.

	Traditional (Pre-tax)	**Roth**
Contribution	$20,000	$20,000
Income tax savings (32%)	(6,400)	
Net Outlay	13,600	20,000
Growth:		
Contribution	20,000	20,000
Earnings[1]	18,975	18,975
Total	38,975	38,975
Withdrawal at various combined incremental rates:		
32%: (38,975 x .68)	26,503	38,975
Add: Savings on $6,400[2]	10,144	
Total	36,647	38,975
16%: (38,975 x .84)	32,739	38,975
Add: Savings on $6,400[2]	10,144	
Total	42,883	38,975
36%: (38,975 x .64)	24,944	38,975
Add: Savings on $6,400[2]	10,144	
	35,088	38,975

[1] $(20,000 \times 1.10^7) - 20,000 = 18,975$
[2] Assuming annual tax rate of 32%, the after tax return on a 10% return would be 6.8%; $6,400 \times 1.068^7 = 10,144$ Note the assumption of a constant 32% combined rate for all years.) (It is assumed that the $6,400 of tax savings could not be saved in an IRA on a tax-deductible basis.)

Note: The break-even tax rate in retirement is 26.027%, because (38,975 x .73973) + 10,144 = 38,975. Note that this rate is substantially <u>lower</u> than the incremental rate applicable when earned.

End of analysis? …

Sample Calculations
Benefits of Rollover to Roth IRA

III. Assume the person in Calculation II (in a net 32% bracket) contributed $20,000 each year from age 58 in 2006 to age 64 in year 2012 and attained age 65 in 2013. (Through an extension of the sunset, the ability to make Roth 401(k) contributions is assumed to continue through 2012.) Assume annual earnings (inside or outside the plan) of 10% until 2013, and 8% thereafter. The person would thus have accumulated $208,699 of Roth 401(k) benefits or $208,699 of traditional 401(k) benefits. Assume the person: (a) is entitled to $30,000 of annual pension benefits beginning at age 65; (b) has assets that produce $8,000 of taxable interest and fully-taxable (not qualified) dividends in 2014, and this amount is assumed to grow at 2.5% per year; and (c) is entitled to $18,000 of Social Security benefits in 2014, and this amount is increased 2.5% per year under Social Security's COLA. Further assume that the participant is married, and that the Roth 401(k) benefits are rolled over to a Roth IRA at age 65. The traditional 401(k) benefits are rolled over to a traditional IRA at age 65. The annual tax savings from a traditional IRA are those supplied in Calculation II ($6,400 per year), and the earnings thereon are included in the calculations. The participant doesn't take any discretionary distributions from the IRA (Roth or traditional). Mandatory §401(a)(9) distributions are made from the traditional IRA after attainment of age 70½. The participant dies shortly after his spouse dies at age 80, and the IRA's proceeds (Roth or traditional) are distributed to the participant's children and/or grandchildren. (The participant's spouse was his designated death beneficiary prior to her death.) The comparison below is of a Roth 401(k) plan's benefits to a traditional 401(k) plan's benefits, given the minimum distributions under a pre-tax plan following attainment of age 70½. Importantly, note that Roth distributions are not taken into account for income taxation of Social Security purposes, while distributions from a traditional IRA increase the amount of Social Security income that is taxable.

	Traditional	**Roth**
Total Contributions and Earnings[2]	208,699	208,699
Accumulation to age 71 @ 8%/year[3]	331,179	331,179
Withdrawal at age 71[4](divided by 26.5)	12,497	
Incremental Tax[5]	(5,955)	
Net Received	6,542	
IRA, reduced for 401(a)(9) amount	318,682	331,179
Growth to Next Year (x1.08)	344,176	357,673
Withdrawal at age 72[3] (divided by 25.6)	13,444	
Incremental Tax[4]	(6,332)	
Net Received	7,112	

(continued on next page)

[2] $(20{,}000 \times 1.10^7) + (20{,}000 \times 1.10^6) + (20{,}000 \times 1.10^5) + (20{,}000 \times 1.10^4) + (20{,}000 \times 1.10^3) + (20{,}000 \times 1.10^2) + (20{,}000 \times 1.1) = 208{,}699$.
[3] $(208{,}699 \times 1.08^6) = 331{,}179$.
[4] Utilizing the Uniform Lifetime Table.
[5] This amount is the excess of the traditional tax scenario over the Roth tax scenario. The tax brackets, personal exemptions, Social Security income tax provisions and the standard deduction have been indexed for inflation at 2.5% per year. A 5% State rate is assumed. The incremental federal rate for all years with respect to the traditional 401(k) is 15%. The only deductions are for personal exemptions and the age 65 or older (taxpayers and spouse) increased standard deduction exemption.

Calculation III, continued:

	Traditional	Roth
IRA, Reduced for §401(a)(9) Amount	330,732	
Growth to Next Year (x1.08)	357,191	386,287
Withdrawal at age 73[6] (divided by 24.7)	14,461	
Incremental Tax[7]	(6,734)	
Net Received	7,727	
IRA, Reduced for §401(a)(9) Amount	342,730	
Growth Next Year (x1.08)	370,148	417,190
Withdrawal at age 74[5] (divided by 23.8)	15,552	
Incremental Tax[6]	(7,176)	
Net Received	8,376	
IRA, Reduced for §401(a)(9) Amount	354,596	
Growth Next Year (x1.08)	382,964	450,565
Withdrawal at age 75[5](divided by 22.9)	16,723	
Incremental Tax[6]	(7,655)	
Net Received	9,068	
IRA, Reduced for §401(a)(9) Amount	366,241	
Growth Next Year (x1.08)	395,540	486,610
Withdrawal at age 76[5] (divided by 22.0)	17,979	
Incremental Tax[6]	(8,174)	
Net Received	9,805	
IRA, Reduced for §401(a)(9) Amount	377,561	
Growth Next Year (x.1.08)	407,766	525,539
Withdrawal at age 77[5] (divided by 21.2)	19,234	
Incremental Tax[6]	(8,692)	
Net Received	10,542	
IRA, Reduced for §401(a)(9) Amount	388,532	
Growth Next Year (x1.08)	419,615	567,582
Withdrawal at age 78[5] (divided by 20.3)	20,671	
Incremental Tax [6]	(9,225)	
Net Received	11,446	
IRA, Reduced for §401(a)(9) Amount	398,944	
Growth Next Year (x1.08)	430,860	612,989
Withdrawal at age 79[5] (divided by 19.5)	22,095	
Incremental Tax[6]	(9,744)	
Net Received	12,351	
IRA, Reduced for §401(a)(9) Amount	408,765	
Growth Next Year (x1.08)	441,466	662,028

(continued on next page)

[6] Utilizing the Uniform Lifetime Table.

[7] This amount is the excess of the traditional tax scenario over the Roth tax scenario. The tax brackets, personal exemptions, Social Security tax provisions and the standard deduction have been indexed for inflation at 2.5% per year. A 5% State rate is assumed. The incremental federal rate for all years with respect to the traditional 401(k) is 15%. The only deductions are for personal exemptions and the age 65 or older (taxpayers and spouse) increased standard deduction exemption.

Calculation III, continued:

	Traditional	Roth
Withdrawal at age 80[5] (divided by 18.7)	23,608	
Incremental Tax[6]	(10,392)	
Net Received	13,216	
IRA, Reduced for §401(a)(9) Amount	417,858	
Growth Until Death[8] (x1.02)	426,215	675,269
Tax on Distributions (29.5%)	(125,733)	0
Net	300,482	675,269
Growth of Tax Savings[8]	170,517	0
Growth of Net Minimum Distributions[9]	126,628	0
Totals to Heirs	**$597,627**	**$675,269**

Note that the compounded complete tax-free growth has made a Roth 401(k) contribution more valuable than a traditional 401(k) contribution, where the incremental net income tax rate dropped from 32% while working to 20% in retirement.

Every participant will have a different situation. To perform analysis, a significant number of guesstimates must be made for future investment returns, future retirement income needs, future inflation and, of course, future tax rates and the future tax system.

Note: A software program could be created to allow employees to input their own assumptions. The significance of future tax rates is obvious.

Caveat: These figures are not 100% accurate, but the creator believes that they are materially accurate.

5. Utilizing the Uniform LifeTime Table.

6 This amount is the excess of the traditional tax scenario over the Roth tax scenario. The tax brackets, personal exemptions, Social Security income tax provisions and the standard deductions have been indexed for inflation at 2.5% per year. A 5% State rate is assumed. The incremental federal rate for all years with respect to the traditional 401(k) is 15%. The only deductions are for personal exemptions and the age 65 or older (taxpayers and spouse) increased standard deduction exemption.

8 Assume he dies 3 months into the year, and no tax is due.

8 This savings is the original savings produced by making a traditional 401(k) contribution, instead of a Roth 401(k) contribution. It was $6,400 per year. The savings have been grown to retirement age by 1.068% per year, and have been grown by 1.064% (i.e. 1 + (0.08x.8)) thereafter until age 71 (assuming a 10% return rate and a 32% tax rate pre-retirement and an 8% return and a 20% tax rate post-retirement); no tax reduction is made after age 71 (so, the growth is 8% per year), since the incremental taxes on these savings were taken out in the annual incremental tax calculations above.

9 The minimum distribution amount for each year has been grown by 1.064% (i.e. (1+(.08x.80)) for each year.

Pros and Cons Summary - For Consideration by the Employer

ROTH 401(k) PROS/CONS

Pros

- Adds an option that would be considered to be valuable to some employees
- Allows a participant to achieve "tax diversity" by creating an after-tax account (ordinarily, all amounts distributed from a Roth 401(k) account at retirement are tax-free)
- Adding the option to a retirement benefits program cannot hurt from a competitive standpoint, since some competitive employers will very likely offer the option
- Amounts can be rolled over to a Roth IRA for tax-free growth beyond age 70½ without minimum annual distributions (unlike pre-tax retirement benefits)

Cons

- Adds another layer of complexity to plan administration, including additional administrative costs
- Uncertainty of tax system makes value of an election difficult for an employee to gauge

NOTE: Was supplied to participants in December of 2005

ROTH 401(k) OPTION

Beginning on March 1, 2006, you will be able to make a "Roth" 401(k) election with respect to some or all of the voluntary (elective) deferrals that you make to the Smith Moore LLP Associates and Of Counsel Profit Sharing and Savings Plan (the "Plan").

Currently, all elective deferrals that you make to the Plan are made on a pre-tax basis, meaning the contributions reduce your W-2 (or K-1s, for partners) compensation figure that is subject to income taxation. However, all distributions from the Plan (or from another plan or IRA if you roll over your distribution from the Plan) are subject to income tax at the time of distribution.

If you make a Roth election, your elective deferral contributions that are subject to the election will not reduce your W-2 (or K-1 for partners) compensation that is subject to income taxation. However, distributions of Roth 401(k) elective deferrals and earnings thereon after retirement ordinarily are completely tax-free, whether received from the Plan or from a rollover IRA that you create (as a Roth IRA) to receive your Plan benefits upon distribution. (Both regular elective deferrals and Roth elective deferrals are subject to Social Security and Medicare tax upon contribution.)

You are not required to make a Roth election. Instead, you can continue making traditional pre-tax elective deferrals. Alternatively, you can elect that part of your elective deferrals are subject to a Roth election, and part of your elective deferrals are traditional (pre-tax) elective deferrals.

For people under age 50, the maximum amount of 401(k) elective deferrals that can be made for 2006 is $15,000. For people age 50 or older, an additional $5,000 of "catch-up" elective deferrals can be made. Thus, if you wish to "max out" on elective deferrals for 2006, and you wish for all of your elective deferrals to be Roth elective deferrals, you will need to make $0 of elective deferrals for January and February of 2006, and then defer the maximum amount available to you ($15,000 or $20,000) over the remaining 10 months of 2006. (Contact Schwab at 1-800-724-7526 to make changes.)

Addition of the Roth 401(k) option will have no impact on profit sharing contributions to the Plan. Those contributions will continue to be made on a pre-tax basis.

Who should make a Roth election? Whether you should make a Roth election depends on your personal financial situation and your expectations regarding future taxes. Generally, if your incremental income tax bracket during retirement will exceed your incremental income tax bracket when you make the elective deferral contributions, a Roth 401(k) election would be advantageous to you. However, depending on the situation, a Roth election can be profitable to you if your incremental tax rate in retirement will be lower, and sometimes significantly lower, than your incremental tax rate when contributions are made. Also, a Roth 401(k) account can ordinarily be rolled over tax-free to a Roth IRA. A Roth IRA is not subject to the minimum required distributions rule of Internal Revenue Code section 401(a)(9) at age 70-1/2 and, thus, no distributions are required from a Roth IRA until death. Unfortunately, no one knows the future of the tax systems of the U.S. and the various States. Thus, there lies an element of risk in making a Roth 401(k) election. However, making a Roth 401(k) election would provide some "tax diversity," by making part of your retirement benefits tax-free.

Under current law, the ability to make Roth 401(k) contributions expires after 2010.

Call Charles Schwab or go online at www.schwabplan.com to make a Roth 401(k) election.