

# Roth Contribution Errors

## *A Segment in Our Retirement Rescue Series*

*A common feature in 401(k), 403(b), and 457 plans is the option for employees to designate all or a portion of their elective deferrals as post-tax Roth contributions. However, this option may increase the likelihood of administrative errors.*

*Does your Plan need to be rescued?*

### **Pre-Tax versus Roth Contributions**

The difference between pre-tax and Roth deferrals is the time of taxation. Pre-tax deferrals are made from gross income, before it is taxed. Pre-tax dollars in a retirement account are taxed upon withdrawal. In contrast, Roth deferrals are made from net income which has already been taxed. Roth dollars in a retirement account are not taxed (subject to certain restrictions) upon withdrawal as this would be double taxation. Pre-tax contributions are considered the traditional form of retirement plan contributions, however, giving participants the option to elect Roth deferrals is a growing trend. For participants that have the option to choose either pre-tax or Roth contributions, or a combination, the deciding factor is often based on when they plan on being in a lower tax bracket - now or in retirement.

While allowing participants to choose between pre-tax and Roth contributions gives them more flexibility in their retirement savings, it may increase the chance of errors in administering deferral elections.

### **The Error**

If an employee elects for Roth, post-tax deferrals and instead, contributions are made from pre-tax income, an error has occurred. Similarly, an error has occurred if the employee elects for pre-tax deferrals but contributions are instead made from after-tax dollars. Correction is necessary to put the Participant's account in the position it would be in had their election been properly implemented, however there is no standard correction from the IRS. In Revenue Procedure 2008-50 and Revenue Procedure 2013-12, the IRS requests comments regarding appropriate correction of these failures. Specifically, the IRS requested comments on which of the following correction methods best rectifies the error and if the Participant should be able to choose which method is used.

### **Possible Correction Methods**

1. A transfer of the contribution (with earnings) to the proper account, based on the participant's election. The employer will issue a corrected W-2 for the year of the failure and the participant will file an amended tax return for the year of the failure.
2. [For deferrals erroneously made from pre-tax income] A transfer of the contribution (with earnings) to a Roth account and the employer makes a "gross up" payment to the participant to cover the resulting income tax.
3. [For deferrals erroneously made from pre-tax income] A transfer of the contribution (with earnings) to a Roth account and inclusion of the amount transferred in the participant's compensation in the year of the transfer.

Until further guidance is provided by the IRS, the employer should choose the correction method above that best rectifies the failure and puts the participant's account in the position it would be in had the error not occurred.