Arnerich Massena
Building Better Portfolios

Roth Retirement Savings: More Accessible Than Ever

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Roth Retirement Savings: More Accessible Than Ever

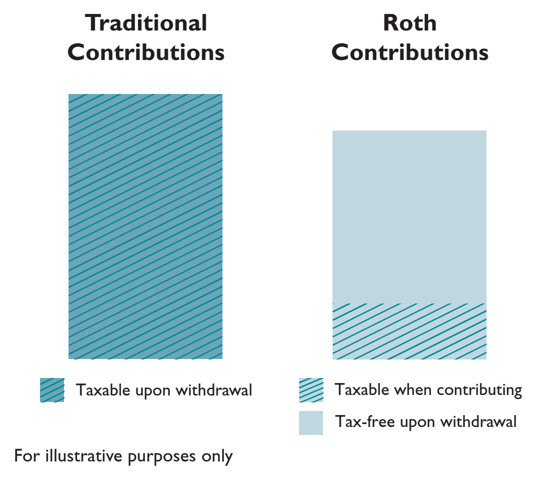
The 2012 fiscal cliff legislation brought us, among other things, a new regulation making in-plan conversions to a Roth option more easily accessible; now, participants don't have to retire or separate from service to convert assets from a pre-tax account into a Roth. The only catch is that this legislation applies only to those plans that offer the option for all participants to contribute to a Roth account and that allow Roth conversions.

With the American Taxpayer Relief Act of 2012, Congress provided retirement plan sponsors with another reason to consider adding a Roth option to their retirement plan if they don't already have one. By 2011, almost half of all participant-directed retirement plans allowed Roth after-tax contributions, up from only 37 percent in 2008. *(PSCA, 2012)* Employers are recognizing the significant benefits a Roth option offers to certain participants, and the new law provides an impetus for taking a deeper look at why you may want to consider adding a Roth option. In this paper, we'll discuss how a Roth option may be a valuable addition to a retirement plan, and considerations for plan sponsors when deciding whether or not to offer Roth contributions.

How are Roth contributions different from traditional pre-tax contributions?

In a traditional tax-deferred retirement plan, participants make their contributions pre-tax and their savings then grow tax-deferred. Their money is taxed as they withdraw it in retirement. Roth contributions are made on an after-tax basis; the savings grow without being taxed, and all qualifed withdrawals are free of federal and most states' taxes. Roth contributions to employer-sponsored retirement plans are very similar to contributions to a Roth IRA, with one very significant difference. Roth IRAs have an income limit — higher-income individuals are not able to contribute to a Roth IRA — whereas all participants, no matter their income level, can make Roth contributions to their retirement plan up to plan contribution limits.

Traditional contributions may allow a participant to save more in the plan, since savings are made pre-tax, but all of the contributions and any earnings will be taxed upon withdrawal. Because Roth contributions are made after tax, participants may save slightly less each month. However, only the contributions are taxed; any earnings are free of federal and (in most cases) state taxes, provided withdrawals are qualified.



For illustrative purposes only

Conversion opportunity under the American Taxpayer Relief Act of 2012

Since 2010, in-plan conversions to a Roth account have been available to participants in 401(k), 403(b), and 457 plans. Participants in an employer-sponsored retirement plan were able to convert pre-tax savings into a tax-free Roth account, provided the plan offered a Roth option. However, this option was only available if there was a qualifying event allowing the participant to take a regular distribution, such as separation from service or retirement. This severely limited the availability of the conversion option to active participants, making it inaccessible to most workers until retirement. The American Taxpayer Relief Act of 2012 amends the tax code so that participants no longer need a qualifying event to make an in-plan conversion to a Roth account. They are now allowed to make a conversion at any time of any portion of their pre-tax savings into a Roth option. Again, this applies only to plans that offer a Roth option and that allow Roth conversions.

In order to convert pre-tax dollars into tax-free dollars, taxes have to be paid. When a participant makes a conversion, the amount converted is counted as ordinary income for the year in which the conversion is made, and taxed as such. For this reason, participants who execute a conversion must plan for the additional income tax and have the means to pay the taxes from out-of-plan dollars. (The primary reason for this amendment as part of the fiscal cliff legislation was the expected additional tax revenue it would bring immediately to government coffers, but that doesn't discount the advantages it brings to participants as well.) This conversion process exempts participants from the 10% early withdrawal penalty tax (which distributions from their traditional plan account would normally entail); only regular income taxes on the amount converted are due. Once a conversion is made to a Roth account, it is permanent and cannot be reversed (unlike conversions from a traditional IRA to a Roth IRA, in which account-holders have the opportunity to reverse the decision at the end of the year if they deem the tax consequences unfavorable).

In spite of the immediate tax consequences, many participants are likely to find the long-term tax benefit of a Roth account worth the short-term impact of additional income taxes, regardless of whether future tax rates increase or not.

How does a Roth option benefit participants?

The potential tax benefit from a Roth retirement account can be significant, and is a great benefit for many, just as is a traditional pre-tax account. How much a participant will benefit from a Roth account versus a traditional account depends on their personal situation and preferences. However, there are some participant groups who will likely find a Roth account particularly advantageous.

Younger employees who are starting to save early will likely find that when they reach retirement, their retirement account is made

> "Employers need to be aware of all retirement strategies available to their employees, especially if they want to remain competitive. Roth 401(k)s [and 403(b)s and 457s] can be another valuable option that employers can bring to the table."
>
> *– Field, 2012*

What are qualified withdrawals?

For withdrawals from a Roth account to be tax-free, the account must have been held for at least five years and the participant must be at least age 59 ½ and have permanently separated from service.

up of a greater proportion of earnings than contributions. Because earnings can be entirely tax-free in a Roth account, this can be a powerful tax benefit.

While many people anticipate a lower income after they retire, some people may face a higher tax rate in retirement, and many people anticipate that taxes will increase in the future regardless of their tax bracket. In a Roth account, they pay current taxes and avoid the higher expected taxes in the future.

Highly compensated employees may find a Roth account appealing. Because the Roth option within a retirement plan doesn't have the income limitations of a Roth IRA, this is the primary option whereby high-income earners are able to save in a retirement account that offers tax-free withdrawals. Also, taxes have been at a historical low for high earners and many expect they will increase in the future, making the possibility of avoiding future taxes attractive.

Roth retirement accounts can also simplify the de-cumulation phase for retirees. A Roth account can easily be rolled over into a Roth IRA, which has no required minimum distributions. This allows the account to continue to grow tax-free even into retirement, particularly helpful if the participant has traditional tax-deferrred savings that must be withdrawn on schedule. Furthermore, the account can be passed on to a beneficiary, continuing the tax advantages into the next generation.

The table in Figure 1 compares the features and benefits of a traditional pre-tax retirement plan account, a Roth retirement plan account, and a Roth IRA.

Figure 1: Comparison of Benefits of Traditional Pre-tax Account, Roth Account, and Roth IRA

Traditional Pre-tax Retirement Plan Account	Roth Retirement Plan Account	Roth IRA
Employee contributions are made before taxes are withheld.	Employee contributions are made after-tax.	Contributions are made with after-tax dollars.
May contribute up to the IRS maximum ($17,500 for 2013 with a $5,500 catch-up contribution for those age 50 and over).	May contribute up to the IRS maximum ($17,500 for 2013 with a $5,500 catch-up contribution for those age 50 and over).	May contribute up to the IRS maximum ($5,500 for 2013, $6,500 for those age 50 and over).
No income limitation to participate.	No income limitation to participate.	Income limits apply.
Savings grow tax-deferred.	Savings grow tax-free (provided withdrawals are qualified).	Savings grow tax-free (provided withdrawals are qualified).
Withdrawals are taxed as regular income.	Qualified withdrawals are tax-free.	Qualified withdrawals are tax-free.
Required minimum distributions begin at age 70 ½.	Required minimum distributions begin at age 70 ½.	No required minimum distributions.

Considerations before adding a Roth option

The addition of a Roth contribution option to a retirement plan is both a fiduciary and administrative decision. If you recognize the value of a Roth option to participants, as more and more plan sponsors do, there are not many obstacles to implementation. However, there are a few issues you should consider.

Recordkeeping expenses should not change with the addition of Roth contributions to the plan. If fees change significantly, you might consider renegotiating or reevaluating your recordkeeper relationship.

The addition of a Roth contribution option to your plan will require some internal administrative changes. You will need to amend plan documents to reflect the new option and adjust the payroll process to discern between pre-tax contributions and post-tax contributions.

> "Other than the relatively minor administrative cost of adding a Roth… component to an existing…plan and a little extra accounting, there is really no downside for an employer. Any employer that would like to add value to their employees' retirement options without having to spend a significant amount of money should add the Roth…components to their existing…retirement plan."
>
> *– Lange, 2010*

Those participants who convert pre-tax assets into a Roth account will have to pay regular income taxes on the amount converted, in the year in which they convert. This will require the distribution of 1099 forms, detailing the withdrawal amounts for income tax purposes. The plan recordkeeper should be responsible for issuing the appropriate 1099 forms, but you will want to ensure that they have a process in place for doing so.

One of the most important considerations is that of designing a communication program to explain the benefits of Roth contributions and how they differ from traditional contributions to participants. Such a program would ideally incorporate information about the conversion opportunity so that participants have a full understanding of the options available to them, as well as an awareness of the tax ramifications of converting assets to a Roth account.

What do your participants need to know about the Roth option?

When developing a plan for communicating the new Roth contribution option to your participants, these points will be important to cover:

- What is a Roth account and how is it different from a traditional pre-tax account?
- What is the tax benefit of a Roth account?
- How much are participants allowed to contribute to a Roth account, and how do contributions work?
- What happens to participants' employer match if they choose a Roth option?

- How do withdrawals work in a Roth account?
- How does a conversion to a Roth account work? What are the important tax considerations of making a conversion?

To allow Roth contributions and conversions or not?

As a fiduciary, your responsibility is ultimately to act on behalf of your participants and their beneficiaries. To help make a decision, consider whether or not your participants would embrace a Roth option.

- Is your participant base likely to take advantage of a Roth account?
- Do many of your employees belong to one of the participant groups likely to benefit most from contributing to a Roth?
- Is the level of financial sophistication great enough that participants will understand the benefits of a Roth and be able to make an informed decision about which option would be most appropriate?
- Have participants asked about or requested a Roth option? Consider doing a brief survey to find out what your participants think.

If you come to the conclusion that a Roth option will be of value to your participants, now may be the time to add it to your plan. With the fiscal cliff legislation allowing in-plan Roth conversions, people will be particularly interested in examining the benefits of a Roth. You can work with your plan's advisor and recordkeeper to make the necessary administrative changes and develop an education and communication program for participants.

> "Among companies using 401(k) plans from Vanguard, 46% offered the Roth option in 2011, up from 12% in 2006. At Fidelity, 32% of employers offer the plan, up from 5% over the same period. Schwab's recent figure is the highest, with 66% of plan sponsors offering the Roth in 2011, up from 30% in 2006."
>
> *– Ensign, 2012*

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