ROTH REVISITED

HIGHER PROSPECTIVE TAX RATES RENEW INTEREST IN ROTH 401(k)S AND 403(b)S

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Introduction

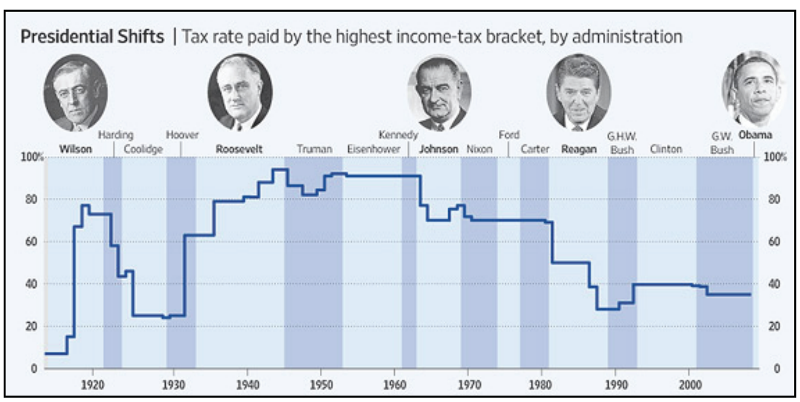
Higher prospective tax rates are renewing interest in Roth 401(k)s and 403(b)s. This paper summarizes the technical aspects of the Roth feature, illustrates the tax diversification value, and sets out things to think about before adding the option to your plan. Due to the lead time involved with adding the Roth feature, plan sponsors should consider putting it on their agenda this summer or fall if they are potentially interested in introducing Roth contributions on January 1, 2010. Because this is not an investment matter per se, the audience for this paper may be your Benefit or Administration Committee rather than your Investment Committee.

Paul J. Kerry, Senior Consultant, co-authored this paper. Paul joined NEPC in June 2009 and has over thirty years of consulting experience in the design and administration of qualified and non-qualified retirement programs. He is available to our clients as a resource for understanding the Roth 401(k) and 403(b), and implementing this optional feature in their programs.

Background

Plans have been able to offer the Roth option since 2006, and about 18% of NEPC's defined contribution clients offer the feature. Industry-wide the percentage is about 30% according to the PSCA's 51st Annual Survey of Profit Sharing and 401(k) Plans, which is based on 2007 plan experience. This is good news after only two years in the marketplace, and we expect the trend to continue to increase.

If you've looked at Roth before and weighed the pros and cons, why might you take another look at the Roth feature for your 401(k) or 403(b) plan? The answer is straightforward: tax rates are widely expected to go up. Cities, states and the federal government have widening fiscal deficits and crushing debt burdens, and higher taxes across the board might be a reality. Roth contributions allow participants the ability to pay their taxes forward (over their savings years rather than their retirement years), which is a way to tax diversify, or dollar-cost-average their taxes. The illustration below, care of the Wall Street Journal last month, is a reminder of just how variable federal income tax rates have been over the past 80 years.



Overview of Roth 401(k) and 403(b)

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) added Section 402A to the Internal Revenue Code to allow Section 401(k) and 403(b) plans to provide for designated Roth contributions beginning January 1, 2006. The Roth provisions were initially set to sunset on December 31, 2010, but were made permanent by the Pension Protection Act of 2006 (PPA).

The difference between a Roth 401(k) or 403(b) and a traditional 401(k) or 403(b) is that the Roth version is funded with after-tax dollars while the traditional 401(k) or 403(b) is funded with pre-tax dollars.

Even though Roth contributions are after-tax, they are treated as elective deferrals for the Section 402(g) limit ($16,500 in 2009, $22,000 if over age 50) and non-discrimination (ADP) testing purposes in 401(k) plans. Distributions from a Roth are completely tax free if certain conditions are met.

Technical Aspects of Roth Contributions

Roth features can be established in a 401(k) or 403(b) plan, but not in a 457 plan. The Roth feature is completely optional, but if desired, it can only be included as another plan feature, i.e. it cannot stand alone. Practically speaking, this means participants must be given a choice between the pre-tax and Roth feature, and may be allowed to split contributions between the two if permitted by plan design. Roth contributions and their earnings must be accounted for separately from the pre-tax accounts in the plan and also regular after-tax contributions, if offered.

Roth contributions need not be offered to all eligible participants, but if they are not, the plan will be subject to additional non-discrimination requirements called benefits, rights, and features testing under IRC Section 410(b).

Since Roth contributions are *employee* contributions, they must be 100% vested and may be matched by the plan sponsor. If the plan sponsor provides a match on pre-tax contributions, they may also match Roth contributions, but are not required to do so. Any Roth matching contributions must be designated to a plan sponsor's pre-tax account and can be commingled with existing pre-tax matching contributions. Safe harbor plans may include Roth contributions as well.

If an automatic enrollment feature exists, the plan sponsor can decide to automatically enroll participants in the Roth or the pre-tax feature. Roth contributions can also be included in the hierarchies for loans and hardship withdrawals.

Distributions

Roth distributions are completely tax free to the participant if the "Qualified Distribution" rules are satisfied. A Qualified Distribution is a distribution that is made after the participant attains age 59 1/2, becomes disabled, or dies, *and* after the five year period ("exclusion period") beginning with the 1st taxable year for which a Roth contribution was made under the plan (or a prior Roth account if rolled into the subject Roth plan). If the distribution does not satisfy the above "Qualified" rules, it is considered a non-qualified distribution and the earnings will be subject to taxes and possible early distribution penalties.

Rollover Technicalities, i.e. Portability

Participants may roll funds *into* a Roth 401(k) or 403(b) plan only from another Roth 401(k) or 403 (b), but not from a Roth IRA. Participants may roll funds *out of* a Roth 401(k) or 403(b) to a Roth IRA.

The sixty-day rollover window is available for a rollover from a qualified plan to an IRA, but a direct rollover is required from one qualified plan to another qualified plan. If a direct rollover of Roth funds is made to another qualified plan, the starting point for the five year exclusion period carries over to the new plan. This is not the case, however, if the participant does not rollover the Roth source into the new plan. The five year exclusion period restarts if Roth funds are rolled over into a newly-established Roth IRA. However, the exclusion period only applies to investment earnings transferred to the Roth IRA (unless the participant already has a Roth IRA in which case the exclusion period would be based on the existing Roth IRA). Finally, a rollover from a Roth 401 (k) to a Roth IRA due to death or divorce, does not result in the five year exclusion period restart.

Why Would a Plan Sponsor Want to Offer Roth?

Plan sponsors go to great lengths and expense to provide their employees with a tax qualified vehicle to accumulate funds for retirement. Why not make it more flexible for those who want to take advantage?

There can be many benefits for plan participants. Benefit one: tax rates are expected to increase. If participants expect to be in a higher tax bracket when distributions begin than they are today, they could be better off by paying taxes on their contributions today at the lower rates (see examples that follow). If they believe the opposite (that tax rates will be lower at distribution), they may be better served with pre-tax deferrals today. Although, in fact, even if tax rates are lower in retirement, having a pool of tax free income to draw on may help put participants in a lower tax bracket. In any case, the tax diversification notion is a primary driver of Roth 401(k) and 403(b) implementations.

Benefit two: participants can contribute as much as $16,500 ($22,000 if over age 50) for 2009 to a Roth 401(k) or 403(b), as compared to the $5,000 ($6,000 if over age 50) contribution limits associated with a Roth IRA. Moreover, some highly paid participants are either limited or cannot contribute to a Roth IRA because of income limits for individuals ($105,000 phased out at $120,000) and families ($166,000 phased out at $176,000). There are currently no income limits with the Roth 401(k) or 403(b).

Benefits three and four: participants can avoid Minimum Required Distributions (MRDs) at age 70 1/2 by rolling the Roth 401(k) or 403(b) amounts into a Roth IRA (which does not require MRDs), and Roth 401(k) and 403(b) amounts are not included in the earnings test to determine the taxation of Social Security benefits.

Adopting Roth Is Not Without Sacrifice

Adopting a Roth feature requires updates to your plan document, summary plan description, administration manual, and enrollment materials. Payroll will need to establish a Roth contribution deduction code, tax withholding, and appropriate W-2 reporting. Systems that interact with the plan administrator will require updates for additional data elements for Roth sources and Roth contribution elections. Plan communication and education materials will also require modifications. Finally, plan design decisions on how to integrate Roth into the existing program will need to be made (e.g. should Roth be matched? Should Roth be available for withdrawal or loans?).

When Roth was first introduced, many practitioners believed that participant utilization would be low due to the complex nature of the topic. This suggested that the incremental time and expense setting up the feature just wouldn't be justified. Survey results counter that thinking, however. PSCA's 51st Annual Survey of Profit Sharing and 401(k) Plans reports that 30% of plans offer Roth and about 12% of participants make Roth contributions. Moreover, most if not all, plan administrators have updated their systems and education materials to accommodate Roth contributions, and in general, adding the Roth option today is much more straightforward and seamless than in 2006.

Roth Illustrations

Plan sponsors considering Roth contributions typically ask us for illustrations, addressing questions like:

- Who benefits? Lower-paid employees or higher-paid employees?
- Is there any benefit for older employees to begin making Roth contributions?

Everyone's frame is different, and the decision to make after-tax deferrals instead of pre-tax deferrals is seemingly pretty complicated for participants. Website resources and calculators abound today, however, much more so than in 2006. It is likely that your service provider has great tools readily available.

Below are three simple illustrations that we use to show plan sponsors the tax diversification benefit of Roth contributions. In each, we use the same assumptions for the accumulation phase (i.e. working years) of a participant's career:

- Participant income tax bracket: 25%
- Annual contribution: $3,000

– Traditional 401(k) deferral: $3,000

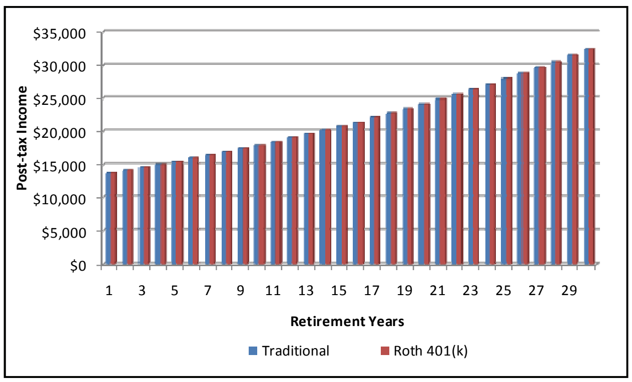
– Roth contribution: $2,250

- Accumulation period: 30 years
- Pre-retirement investment return: 8%

Using these assumptions, the traditional 401(k) account accumulated $367,038 after 30 years, while the Roth account totaled $275,279. During the distribution phase (i.e. retirement), we assumed the following assumptions:

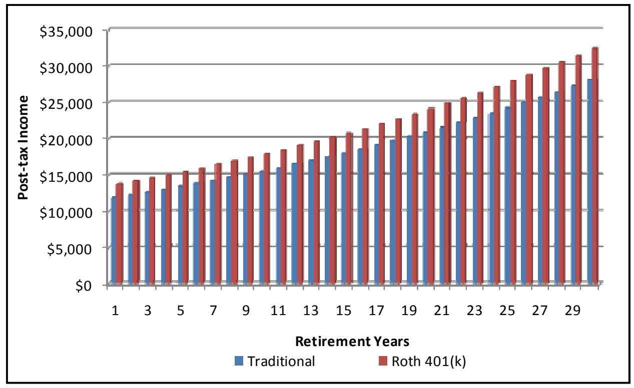
- Post-retirement investment return: 6%
- Annual distribution: 5% of final balance, increased annually with inflation
- Annual inflation rate: 3%

If tax rates do not change and remain at the assumed 25% during the distribution phase, the annual payments provided by the account balances are identical on an after-tax basis. In other words there is no difference between saving in a Roth or a traditional 401(k)/403(b). The illustration below shows identical post-tax income payments of $13,764 in year 1, rising to $32,436 from both the traditional and Roth 401(k)/403(b).



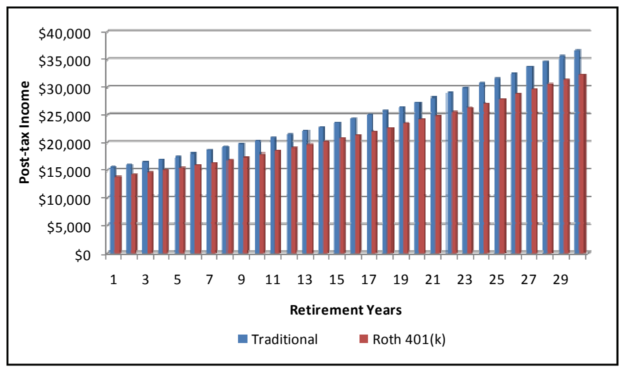
Source: NEPC

If we assume tax rates are higher in the distribution phase (35%) than they were in the accumulation phase (25%), the Roth participant will receive a larger annual distribution than would have been provided from the traditional 401(k)/403(b) plan. This difference in the distribution amounts is the result of the participant paying taxes at a 10% higher rate in retirement than during his/her working years.



Source: NEPC

If, on the other hand, taxes are lower in the distribution phase (15%) than they were during the accumulation phase (25%), the traditional 401 (k)/403(b) participant would receive the larger distribution. The explanation is the reverse of the tax increase example above. Here, the traditional 401(k)/403(b) participant paid taxes at a 10% lower rate during retirement than the Roth participant paid during the accumulation period.



Source: NEPC

Conclusion

The Roth 401(k) and 403(b) have come a long way since their introduction in 2006. About 30% of defined contribution plans now offer a Roth option and 12% of participants utilize it. Experience has shown that some participants understand, embrace and *appreciate* the ability to make Roth contributions within their qualified plans. Moreover, plan service providers have enhanced their systems and communication programs to allow for Roth contributions, which lowers the implementation hurdles today from what they were in 2006. In this paper we illustrated the tax diversification benefit of making Roth contributions, and shared the consensus view that tax rates are likely to rise in coming years.

That being said, Roth isn't for everyone. Adding this feature to your program requires changes to payroll, administration, and communications which likely will still have some hard dollar cost impacts.

Sponsors interested in adding a Roth option should be advised that the ideal time to implement Roth is January 1st to take advantage of the full 12 month calendar tax year. Since plan administrators generally require at least three months lead time to implement new products and services, and January 1st is typically a hectic time for many service providers, a decision to adopt Roth should be made over the summer months. If you are interested in learning more about Roth and would like to discuss plan design options and considerations, please contact your NEPC Consultant.

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