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# The Advantages of Roth 401(k) Contributions

By: Matthew J. Eickman, J.D.
Director of ERISA Services


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**Understanding the Advantages of Roth 401(k) Contributions**

## I. Introduction

A qualified plan sponsor's decision to make the Roth contribution feature available to its employees is no longer merely an emerging trend. The Roth contribution availability has emerged, solidified its presence, and appears to be here to stay. Many would include it among plan sponsor best practices. Some consider it a competitive arrow within the talent acquisition quiver. Yet, despite its wide acceptance and significant appeal, not all sponsors have embraced Roth contributions.

This White Paper is intended to inform and assist two distinct groups of plan sponsors. The first group includes those who, for whatever reason, have not implemented the Roth contribution option. The second group includes those who *have*, but seek a greater understanding of Roth contributions for the purpose of strengthening participant communications. The White Paper will review Congress's steps to permit Roth contributions and explore the various reasons plan sponsors and participants are well-served to take advantage of the Roth opportunity.

## II. Roth 401(k) Contributions: Background & Utilization

One could summarize the difference between pre-tax deferrals and Roth contributions as "tax deferral vs. tax-free growth". The two types of contributions experience inverse tax treatment. Pre-tax deferrals are excluded from income and taxation when contributed to the plan, but the deferrals and earnings are later subject to taxation when distributed. Roth contributions, on the other hand, are included in income and subject to taxation when contributed, but qualified Roth distributions and earnings are distributed tax-free. In order to receive the intended tax treatment, Roth contributions must meet specific requirements, such as being irrevocably designated as Roth contributions when made and subject to separate accounting once made. In addition, there must be a "qualified" distribution, which is made after a five-year period of participation and upon attaining age 59 ½, death, or disability.

Congress acted in two steps to permanently implement the Roth 401(k) option. (This White Paper uses the "Roth 401(k)" term to collectively include qualified Roth contribution programs available under 401(k) and 403(b) plans.[i]) First, it passed EGTRRA (the Economic Growth Tax Relief Reconciliation Act of 2001), which permitted employers to implement a "qualified Roth contribution program" beginning January 1, 2006. EGTRRA included a sunset provision through which the Roth 401(k) option would have expired in 2011. Second, Congress passed PPA (the Pension Protection Act of 2006), which made the Roth 401(k) permanent.

Congress subsequently added – and the Internal Revenue Service clarified – two rollover strategies that facilitate broader implementation and utilization of Roth 401(k) contributions. First, participants may not only roll over Roth 401(k) contributions to a Roth IRA, but also have more flexibility in directing the various destinations of rollovers including both pre- and post-tax contributions.[ii] Second, participants may use an "in-plan Roth rollover" or "in-plan Roth conversion" to convert pre-tax contributions to Roth contributions, without the need to physically receive a distribution or establish a Roth IRA to receive the rollover.[iii]

The move to permanence and availability of additional strategies have served to accelerate the prevalence through which American workers are now able to do what the Roth 401(k) option intended – easily save on an after-tax basis within their employer-sponsored 401(k) plans. Initial implementation was slow-going. Initial studies showed that around one-fourth of employers offered a Roth feature in 2010.[iv] The frequency approached the 50% mark in 2012 and 2013.[v]

By all available accounts, a solid majority of 401(k) plans permit Roth 401(k) plans – and with good reason. One recent survey revealed that 77.6% of 401(k) plans offer a Roth contribution feature. That same survey found that another 9% are considering it within the next 12 months.[vi] Plan sponsors have embraced the advantages of Roth contribution programs: tax diversification, predictability, broad availability, and participant choice in a competitive labor market. As the following exploration of those advantages will demonstrate, the most appropriate question currently surrounding Roth 401(k) programs is: "Why not?"

## III. Understanding Why Participants Appreciate Roth

The primary difference between pre-tax and Roth deferrals is, of course, their tax treatment. Be wary, however, of the conclusion that an employee should make Roth 401(k) deferrals merely because his or her tax bracket "will be higher later". That conclusion is overly simplistic and has little basis in fact; it's merely a prediction relating to something very difficult to predict. Yet there are various other reasons that the difference in tax treatment supports a participant's decision to make Roth 401(k) deferrals.

### A. Diversification

One cannot, with any level of reasonable confidence, predict the tax bracket structure that will be in place when your young employees retire in 30 years. That attempt is similarly futile for your employees who will retire 15, 10, or five years from now. In fact, 2017 Congressional efforts relating to the Affordable Care Act and broader tax reform suggest that the tax structure for 2018 is no sure thing. Frankly, as one expresses more confidence in predictions of future tax bracket structures, those predictions become less worthy of attention.

That future uncertainty supports the advantage of developing diversification in the tax treatment of an individual's retirement savings. Without Roth contributions, most – if not all – of an individual's retirement savings will be subject to taxation upon distribution. It is possible that, at the time of distribution, he or she will face a lower marginal tax rate than what would have applied when he or she initially earned the wages. It is also possible that a *higher* rate will apply at that time. We simply cannot be sure.

Individuals can protect themselves against that uncertainty and an extreme increase in tax rates through diversification. Roth contributions are taxed now, and neither the contributions nor corresponding earnings are taxed upon a qualified distribution. That tax treatment provides diversification.

### B. Predictability

A participant can evaluate whether he or she can meet today's tax burden. It is more challenging to determine whether his or her post-retirement financial situation will accommodate the payment of taxes in future years. Because Roth contributions are taxed when made, they provide an element of predictability.

This is of further importance because a lump sum taxable distribution (such as the distribution of a traditional 401(k) account balance) is subject to mandatory 20% federal tax withholding.[vii] Consider a retiree who encounters the need for a new roof and assumes a replacement cost of $20,000. If he or she desired to use 401(k) plan assets to pay for the new roof, he or she could withdraw $20,000 from a Roth contribution account. In the absence of Roth contributions, however, a $25,000 distribution of traditional pre-tax 401(k) assets would be necessary. The required 20% portion - $5,000 – would be forwarded to the Internal Revenue Service, which would leave $20,000 for the roof. In reality, the participant could experience additional surprises: the possibility of mandatory state income tax withholding in some states, as well as the possibility that a marginal tax rate higher than 20% would result in additional tax liability at the end of the year.

Retirees are commonly quite disappointed to learn that their retirement savings accounts do not have quite the purchasing power they expected. A Roth contribution account helps to manage those expectations through its predictable tax treatment.

### C. Not Subject to IRA Limitations

Congress has provided a mechanism for making Roth contributions outside of a 401(k) plan – to a Roth IRA. But two significant restrictions limit the value of that opportunity. First, the Internal Revenue Code limits the amount that may be contributed for any single year. This limit is $5,500 for 2017. Second, the ability to contribute that maximum becomes limited at specified adjusted gross income (AGI) levels and is then phased out over AGI bands above those levels. A single filer may take advantage of the maximum only if his or her AGI is $118,000 or less (in 2017). For married taxpayers filing jointly, that AGI limit is $186,000 (in 2017). The limits phase out above those levels and disappear at $133,000 and $196,000, respectively. Thus, without Roth 401(k) contribution opportunities, higher wage earners miss out on the opportunity to experience the diversification and predictability advantages highlighted earlier in this paper.

Roth 401(k) contributions are not subject to those same limitations. They are merely subject to the same limitations as apply to traditional pre-tax 401(k) contributions. The annual limit is significantly higher; in 2017 a 401(k) plan participant may contribute up to $18,000 in Roth contributions, plus another $6,000 in the form of catch-up contributions for participants age 50 or older. A younger employee may contribute more than three times what he or she could contribute to a Roth IRA; an older employee may contribute four times as much. In addition, Roth 401(k) contributions are not subject to any AGI limitations. As a result, higher wage earners particularly appreciate Roth 401(k) contribution opportunities because they present the exclusive opportunity to receive the advantages of Roth characterization.

### D. Participants Like Options

Sometimes, participants appreciate options because those options are particularly appealing. Sometimes, it's simpler than that: participants appreciate options because they like options. Plan sponsors without a Roth contribution arrangement may add the feature to present an opportunity to generate additional awareness of (and engagement within) their plans. Plan sponsors that have already implemented a Roth contribution arrangement will include the option among the list of benefit features available to current and prospective employees. It is eye-catching when the Society for Human Resource Management explores the value and prevalence of Roth 401(k) contributions within a research report entitled "2017 Employee Benefits: Remaining Competitive in a Challenging Talent Marketplace".[viii] For various reasons, people like options.

## IV. Closing Thoughts: Why Not?

Several years of data and improvement in payroll processes have knocked down the strawman reasons that held back the implementation of Roth arrangements. Plan sponsors have learned that their employees value the Roth option. Their payroll systems have improved to better accommodate the appropriate coding and tracking. Recordkeepers have modified their systems to separately account for the contributions and their documents to permit them.

In the absence of those barriers, the ideas discussed in this White Paper support the continued implementation and encouragement of Roth contributions: diversification, predictability, higher limits, and the availability of options. Moreover, a recent Harvard study indicates that Roth savers end up with more purchasing power in retirement.[ix] This is because most employees do not reduce their elected savings percentage when making Roth contributions, despite (for example) a 10% Roth contribution having a greater impact on a paycheck than a 10% pre-tax contribution. As participants gain a better understanding of the value of Roth contribution arrangements, it seems likely the corresponding demand and utilization will only continue to increase.


**Questions? Contact the author:**
**meickman@primecap-ia.com**
**402.507.5085**


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[i] *See* IRC § 402A(e)(1) (adding qualified Roth contribution program for 403(b) plans).

[ii] Notice 2014-54.

[iii] IRC § 402A(c)(4)(E); Notice 2010-84; Notice 2013-74.

[iv] *See, e.g.*, Hewitt, "The Role of Roth 401(k) in Retirement Savings", 2010.

[v] Vanguard, "How America Saves 2017 – Vanguard 2016 Defined Contribution Plan Data", June 2017; Deloitte, "Annual Defined Contribution Benchmark Survey – Ease of Use Drives Engagement in Saving for Retirement", 2015.

[vi] Callan, "Defined Contribution Trends", 2017.

[vii] See Form W-4P available at https://www.irs.gov/pub/irs-pdf/fw4p.pdf.

[viii] https://www.shrm.org/hr-today/trends-and-forecasting/research-and-surveys/Documents/2017%20Employee%20Benefits%20Report.pdf.

[ix] Harvard Business School, "Does Front-Loading Taxation Increase Savings?: Evidence from Roth 401(k) Introductions", August 2015.