

TO ROTH OR NOT TO ROTH

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Somewhat surprising Roth 401(k) continues to be a topic that is generating many questions as I travel around the country doing presentations. My initial reaction when the Roth 401(k) was added via EGTRRA was that it would not be a big deal. The January 1, 2006 effective date opened the door for employers to add this feature but usage continues to be limited. My goal in this short article is to focus on the most significant issues surrounding the Roth option rather than explaining what it is and the applicable legal requirements. There are many places, including my web site – www.malvern401k.net, where you can get that information.

I find there is a huge drop in enthusiasm for the Roth option when the audience clearly understands the economic realities. Unfortunately many articles about the Roth IRA when it was first became available created a misperception that the Roth IRA was a huge tax break. Someone could invest \$2,000 for 35 years and never pay tax on the investment income and gains. The perception of a tax give away was enhanced by illustrations that compared a \$2,000 investment into a traditional IRA versus \$2,000 invested into a Roth IRA. These illustrations ignored the added front-end tax cost related to investing \$2,000 into a Roth IRA. A correct economic analysis of Roth versus pre-tax 401(k) or IRA contributions reveals that the financial results are exactly the same if you assume the same tax rate when money is contributed and when it is withdrawn. The following example confirms this fact.

This example assumes a participant is currently making a \$1,000 pre-tax contribution. At a 15% tax rate, the participant must earn \$1,176 to have \$1,000 left after-tax to make a \$1,000 Roth contribution. It is assumed the participant will increase his pre-tax contribution to \$1,176 to match the after-tax cost of making a \$1,000 Roth contribution. A 6% annual investment return is assumed for a 20 year accumulation period. It is assumed the pre-tax contribution is withdrawn in a lump sum and is taxed at a 15% rate.

	<u>Pre-tax Contribution</u>	<u>Roth Contribution</u>
Amount invested annually	\$1,176	\$1,000
Accumulation after 20 years	43,276	36,785
Tax payable at distribution	<u>6,491</u>	<u>0</u>
Net amount after tax	\$36,785	\$36,785

So we must start with the fact that Roth is primarily a tax play – pay Uncle Sam now or later. Historically most professional advisors have pushed tax-deferred savings with the expectation that an individual's tax rate is likely to be lower during retirement due to less earned income. Of course everyone expects tax rates to be higher in the future than they are today. They probably will be but that fact alone does not make Roth the obvious

choice because most retirees experience a significant drop in taxable income during retirement, particularly those whose taxable income is below the level that makes a portion of Social Security benefits taxable. For example, someone who retires today with an earned annual income of \$60,000 is likely to have only roughly \$35,000 of taxable income during retirement prior to considering any deductions. Assume such a retiree's retirement income equals \$48,000, 80% of his final \$60,000 earned income, and further assume \$18,000 of this amount comes from Social Security. The retiree's taxable income prior to deductions is only \$30,000, half of taxable income prior to retirement.

Another myth is that the Roth option produces a big advantage to those who are contributing the \$15,000 (\$20,000 for those who are eligible to make a catch-up contribution) maximum annually. A higher level of income can be produced during retirement if there are no taxes to pay at the time of withdrawal. However, an individual who is in a 33% tax bracket must pay \$9,850 in taxes to have \$20,000 left to invest as a Roth contribution. An alternative is to contribute \$20,000 pre-tax and invest the \$6,600 left after paying \$3,250 of taxes on the \$9,850 earned outside the plan. The financial results will be essentially the same.

Communicating the Roth option to participants is another big challenge. The message to participants is contradictory to what we have told them for years. Participants have been told it costs less to put a \$1.00 into a 401(k) plan due to tax savings. Participants must be told it will cost more to put all or some of what is being contributed into the plan as a Roth contribution because taxes must be paid on the Roth portion. The alternative is for the participant to contribute less into the plan to avoid a drop in take-home pay. This isn't desirable particularly if the reduced contributions will also result in a drop of matching employer contributions.

The following are some other major factors that should be considered by plan sponsors and participants:

- An important goal for participants is to contribute the maximum amount that is matched by the employer. It is easier to do this with pre-tax contributions.
- Employees who are in a 0% Federal tax bracket have nothing to lose by using the Roth option. I was recently informed by the HR Director of a company that many of their employees are in a zero Federal tax bracket including some who earn as much as \$50,000 annually.
- The tax breaks are achieved only for qualifying "distributions". Each participant needs to know what is required to get the tax break.
- The Roth provision totally disappears during 2010. What will happen after that is not known including the tax treatment of Roth contributions made during prior to the expiration date. In my opinion, the future of all EGTRRA related changes are highly questionable at this time.
- Roth contributions are taxable twice when a loan default occurs. Participants who may need to borrow from the plan should consider this fact prior to making any Roth contributions.

- The government can change the rules at any time. As a result, younger participants who expect to escape tax on 30 plus years of investment gains must wonder whether they can trust the government not to change the rules. The track record is not good!!
- Participants who use the Roth should not invest this money in the same many as their pre-tax contributions. Roth is all about avoiding tax on investment gains. As a result, a participant should the investments that have the highest long-term growth potential in the Roth portion of his account. Note: Not all record keeping systems can handle this type of investment split.

The last point is an important one that I have not seen covered elsewhere so I will explain it in more detail with an example. Assume a participant contributes \$10,000 per year and splits this contribution 50/50 between stock and fixed income investments. Further assume the participant decides to split the \$10,000 of future annual contributions making \$5,000 as Roth and the other \$5,000 as pre-tax contributions. I recommend investing 100% of the Roth contributions into the stock investments rather than splitting 50/50 between stocks and bonds. The goal with the Roth option is to get the biggest investment gain possible. As a result, it does not make sense to invest Roth contributions in a money market or stable value account.

Communicating the Roth feature to participants is a huge challenge with this new feature hitting at a time when many participants are overloaded with options. Most participants are already overwhelmed by the amount and complexity of material related to medical and retirement benefits they receive. Adding another choice with the complexity of the Roth option is a challenge and it is not necessary. Plan sponsors are not required to offer the Roth option which is why many have not done so.

I am finding great reluctance on the part of plan sponsors and their advisors to tackle this communication challenge. For years they have been helping participants make informed investment decisions that make sense. Plan sponsors and advisors have become reasonably comfortable explaining plan investments to participants. They are able to provide specific information that can help participants make better investment decisions. The Roth option involves new territory – taxes that are not in their comfort zone. Neither plan sponsors nor advisors are anxious to venture into this new area particularly when it is impossible to give participants really useful advice.