Helping Participants Understand the Advantages of Roth 401(k) Accounts

Low Roth usage by participants may be an education issue.

By Tim Thurston

Since the passage of the Pension Protection Act in 2006, sponsors of most defined contribution plans have had the opportunity to add the Roth 401(k) option to their plans. Later, in 2011 legislation allowed governmental 457(b) plans to add Roth features to their plans. Finally, the American Taxpayer Relief Act of 2012 (ATRA) liberalized Roth provisions by relaxing the in-plan rollover and conversion requirements.

Offering Roth accounts within defined contribution plans has become increasingly common. According to Fidelity, in 2014, 49.4 percent of their plans offered the Roth 401(k) option, an increase from just 5.3 percent in 2006. Plans with as few as 50 participants have more than a 50 percent adoption rate. Adoption rates in larger plans grow to 62.2 percent of the largest plans (5,000+) offering a Roth feature (Fidelity Investments). Even with the increasing availability of the Roth option, its usage by plan participants has lagged behind with fewer than 20 percent of all plan participants making Roth contributions in a given year[1].

In many defined contributions plans, participants may have the option of making three different types of contributions: Roth, before-tax, and after-tax. Before-tax deferrals are deductible from income in the year in which they are made, but principal, interest, and earnings are taxed as ordinary income in the year in which they are distributed. Roth deferrals are not currently deductible, but the principal, interest, and earnings may be withdrawn tax free if the withdrawal is made after five years and attainment of age 59½. After-tax contributions are also not deductible but the interest and earnings grow tax-deferred until distribution.

Due to the differing tax treatments, plan participants may find that making Roth deferrals may present a better financial deal than making before-tax contributions if they expect higher income taxes in the future due to increased earnings, losses of deductions, or higher marginal tax rates. Participants may also find the Roth to be advantageous if:

- they anticipate withdrawals prior to age 59½ since Roth principal is exempt from the 10 percent early withdrawal penalty that applies to before-tax contributions,
- they are constrained by contribution limits on total 401(k) deferrals since a dollar of Roth contributions buys more retirement consumption than a dollar of pre-tax contributions, or if
- they are somewhat underfunded to meet their retirement income needs.

Roth accounts may help slightly-underfunded savers in the same way they may benefit limit-constrained participants, because a dollar of Roth contributions buys more retirement consumption than a dollar of before-tax contributions. Since Roth distributions are tax free, it takes $1 of savings to spend $1. However, pre-tax deferrals are taxed at distribution at ordinary income tax rates. Assuming only federal taxes at a 25 percent tax rate, for your $1, you will have $0.75 to spend. In other words, to spend $1, you would need to withdraw $1.25. Retirees that live in states that tax retirement distributions from pre-tax accounts will also be paying state taxes and their savings will buy them even less than this example.

Plan participants may find that Roth accounts provide options that may be useful to facilitate estate planning. Depending on their needs and circumstances, retirees with Roth 401(k) accounts may roll them into a Roth IRA prior to age 70½, thereby eliminating minimum required distributions. Designated beneficiaries can typically stretch distributions from a Roth account over their lifetimes, allowing Roth assets to grow tax free. Retirees should consult with planning and tax advisors when considering estate planning uses of Roth accounts.

Factors Affecting Participant Use of Roth 401(k)

Plan sponsors often find Roth usage by participants to be driven by inertia, participant preference, length of time as a

[1] Plan Sponsor Council of America

participant in the plan, and incomplete information about the benefits provided by the Roth account.

Research has provided a well-documented understanding that plan participants are passive in their retirement savings accounts (Choi, 2004; Samuelson, 1988). The low current adoption of Roth by plan participants may reflect a sluggish response to its introduction rather than an active preference for before-tax deferrals. Research conducted by AON Hewitt and others indicate that there is a significant difference between new hires and participants who have participated in the plan prior to the introduction of Roth accounts. According to AON Hewitt, "among participants enrolled in the last two years (2012–2013) more than 14 percent opted to save a portion of their money in a Roth account." In addition, Roth usage is strongly correlated to younger workers with "more than 17 percent of workers in their 20s electing to contribute to a Roth, versus 9 percent of those in their 50s" (Rob Austin, 2014). In our experience during plan transitions, we see an uptick of Roth usage because of messaging during the enrollment period and fresh attention being paid to the plan by participants because of the transition. In one client's plan, 25 percent of participants are making Roth deferrals one year following a change in recordkeepers.

Plan sponsors may find a lack of good information about the differences between Roth IRA accounts and Roth 401(k) accounts. The Internal Revenue Service has certain criteria in order to invest in a Roth IRA account. One set of rules pertains to income limits. For tax year 2014, contributions to a Roth IRA account were reduced for Single tax payers beginning at $114,000 and rose to $189,000 for taxpayers who were married and filing joint returns. No such limit applies to designated Roth contributions made in a Roth 401(k) plan account. During a recent conversation with a plan participant, it became known that the participant was under the impression that he could not make Roth deferrals because his earnings were above the limit.

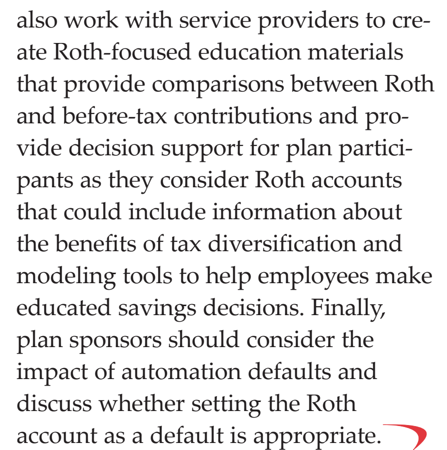
Plan sponsors may also find there to be a large amount of confusion about whether or not Roth accounts make sense for individual plan participants. The decision to contribute to Roth accounts is often based on a plan participant's expectations about federal income tax policy and anticipation of future tax rates. Unfortunately, it is difficult to predict future income tax rates or future income over a period of several years.

Communicating Roth Benefits

Roth 401(k) accounts provide a number of potential planning benefits for plan participants and, indirectly, plan sponsors. Educating participants on these somewhat complex concepts may be the challenge.

Plan sponsors with participant engagement strategies predicated on providing good, useful information to plan participants should find a willing audience for Roth-related information. They may also find that promoting Roth usage among plan participants could prove to have positive effects on annual non-discrimination testing. According to Aon Hewitt, "Among plans that allow Roth contributions, the average deferral rate for Roth users was 10.2 percent, which was considerably higher than the average contribution ratio for the rest of the population (7.7 percent)." (Rob Austin, 2014).

It is clear that Roth availability among plans is growing. More plan sponsors are offering Roth features and more employees are using it. Plan sponsors should consider adding Roth to annual education and communication programs and working with plan service providers to create content regarding the Roth 401(k) account. Communication strategies should include multi-channel and targeted communications. Plan sponsors should



also work with service providers to create Roth-focused education materials that provide comparisons between Roth and before-tax contributions and provide decision support for plan participants as they consider Roth accounts that could include information about the benefits of tax diversification and modeling tools to help employees make educated savings decisions. Finally, plan sponsors should consider the impact of automation defaults and discuss whether setting the Roth account as a default is appropriate.

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