

Time to Consider Adding Roth to the 401(k) Plan

Adding and communicating a Roth-designated account can be well worth the effort, especially in the current environment. The addition of Roth can serve as an excellent way of reinvigorating a plan and re-engaging employees in their efforts to save for retirement.

By **Lori Lucas**

This is the year of the Roth IRA, and that may have implications for defined-contribution plans.

Starting in 2010, salary limits have been eliminated for investors seeking to convert from a traditional IRA to a Roth IRA. (Previously, investors faced an income limit of \$100,000 for such conversions.) Moreover, there's a special rule in place for 2010 that allows investors to spread taxes on the Roth conversion over the next two tax years (2011 and 2012).

All of this may create a wave of rollovers by defined-contribution plan participants who are eligible to roll money out of their plan. After all, if they roll over into a Roth, their earnings can grow tax free. For participants who believe their taxes are likely to be higher in retirement, this can be quite an enticement. And in an environment where the specter of significant tax increases is looming quite large, a Roth's appeal is clear.

Some plan sponsors wonder whether it's possible to prevent the rollovers by adding Roth-designated contributions to the 401(k) plan. Unfortunately, participants with balances in pretax 401(k) accounts cannot perform conversions to a designated Roth account within their 401(k) plans. They must transfer plan assets into an IRA to perform the Roth conversion. (Pretax 401(k) distributions for terminated employees could be rolled directly to existing Roth IRA accounts as of 2008.)

Still, adding a Roth-designated account to a defined-contribution plan may prevent future plan leakage and potentially increase the overall attractiveness of the plan. Today, according

to Callan's 2010 DC Trends Survey, only 37 percent of plans offer a Roth option—despite the fact that the Economic Growth Tax Relief Reconciliation Act made Roth available to 401(k) and 403(b) plans in 2006. Meanwhile, only 7 percent of respondents said they intend to add Roth contributions this year.

One key reason that plan sponsors hesitate to offer Roth-designated accounts is that they fear such accounts will add unnecessary complexity to the plan. With the addition of Roth, record keeping and payroll systems are affected, plan-related documents need to be updated and plan-design impact must be considered. Will the plan match the Roth 401(k) contributions? How will the addition of Roth contributions affect nondiscrimination testing? Should the plan continue to offer traditional after-tax contributions as well?

These are some of the matters that do indeed need to be tackled if a Roth 401(k) is offered in the plan. However, in the nearly half-decade that Roth 401(k)s have been around, defined-contribution plan record keepers have gained considerable experience in guiding plan sponsors through these issues. What's more, many record keepers will support Roth features without charging additional fees.

The second most common reason cited by plan sponsors for failing to offer a Roth is perceived difficulty in communicating the feature to participants. Plan sponsors wonder how, after years of extolling the virtues of pretax savings, they can credibly change their message to incorporate after-tax Roth contribu-

tions. Moreover, they feel challenged in communicating the circumstances under which pretax versus Roth contributions are appropriate for plan participants. It may be daunting to have to provide fact sheets, case studies, calculators and even workshops to help employees understand whether or not Roth contributions make sense for their given situation.

However, for many participants, the decision can be greatly simplified: Do they desire tax diversification or not? Because future tax rates are so uncertain, participants may just wish to split their savings between pretax and Roth 401(k)s. This diversification message will be familiar to participants, and can greatly simplify their decision making (although it will still make sense to offer Roth calculators and related information).

Adding and communicating a Roth designated account can be well worth the effort, especially in the current environment. The addition of Roth can serve as an excellent way of reinvigorating a plan and re-engaging employees in saving for retirement. After all, Roth-designated accounts offer some uniquely attractive features. The recent change to Roth IRA rollovers notwithstanding, Roth IRA contributions are still subject to salary limits. So for higher-salary workers, the Roth 401(k) may be the only way to actively contribute to a Roth account.

Further, Roth IRA contributions are limited to \$5,000 a year (\$6,000 for those 50 and older). However, Roth 401(k) accounts have the higher contribution limits of regular 401(k)s: \$16,500 for 2010 and \$22,000 this year for those 50 or older (with the normal highly compensated employee limits in place as appropriate). Investors seeking meaningful use of a Roth option may find it difficult to achieve it without a 401(k) option. Finally, Roth designated accounts can offer the opportunity for participants to increase their overall saving at retirement by prepaying their taxes.

If you're not convinced that the addition of Roth can enhance

the attractiveness of the plan, consider this: According to a Hewitt Associates report examining participant use of Roth-designated accounts, "when comparing the contribution levels of ... Roth 401(k) contributors before and after their investment in Roth 401(k), the analysis finds that such contributors' overall contribution rates after they elected the Roth 401(k) were higher on average than before electing the Roth 401(k)."

Following the recent battering of defined-contribution plans by the stock market, the elimination of company matching contributions by numerous employers and the economic hardships that may be hampering participants' ability to save, anything that can improve a plan's attractiveness certainly merits consideration.

One final reason to consider Roth: The potential for significant leakage out of defined-contribution plans and into retail Roth IRAs is of such concern that the U.S. Senate recently approved a bill that would permit 401(k) plan participants to convert pretax contributions to a Roth account within their 401(k) plan. If the bill becomes law, the demand for Roth-designated 401(k) accounts may become greater. This makes exploring the Roth option worth the effort.

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