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Fiduciary Commentary

Winter 2013/2014

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By: Brant Griffin - January 30, 2014

In-Plan Roth Accounts

Recent legislative changes and the growing popularity of Roth accounts have given a growing number of workers the ability to accumulate tax-free savings in retirement plans. As a result, many savers are looking for help to understand how Roth accounts work and if they would be right for them.

Here are the basics: Named after Senator William Roth Jr., a sponsor of IRA reform, the Roth IRA (and the act of converting a traditional IRA to a Roth IRA) was established by the Taxpayer Relief Act of 1997. Roth savings are an alternative to traditional IRAs and defined contribution plans where savings are made pre-tax and distributions are treated as ordinary income for tax purposes. Alternatively, a Roth contribution is made after taxes are paid. Growth on the investments and the money taken out in retirement are not subject to federal income taxation (and usually state and local taxes as well) with few exceptions. This seemingly subtle difference can not only have a major impact on savers today, but have an exponential effect on income in retirement.

In 2006, the Economic Growth and Tax Relief Reconciliation Act permitted defined contribution plans to add a Roth contribution source. Plan sponsors have been steadily adopting Roth features ever since. In 2013, Aon Hewitt's biannual survey of mid-to-large plans found that 50% offered a Roth contribution option that year. That was an increase from 40% in 2011 and 33% in 2009. Roth accounts are quickly becoming a fixture in American's savings strategy.

New regulations could prompt even more sponsors to add Roth features in the future. With this potential increase in Roth accounts around the corner, it is prudent for fiduciaries to begin educating themselves on Roths to explore the advisability of offering this plan feature.

Beyond the Basics

Beyond the frequently cited benefits of Roth savings, the accounts offer many advantages that are not as frequently discussed. These are less tangible and are not easily measured, but can be extremely beneficial to many investors. They include:

- Tax Flexibility in Retirement: There may be an advantage to maintaining retirement assets subject to different rates of taxation. Tax diversification is the strategy of spreading investments across accounts with different tax treatment, such as taxable accounts, tax-deferred accounts, and tax-free accounts. Mixing how withdrawals are taken from different accounts could provide retirees with the ability to optimize retirement income in the most tax-efficient manner.

- Required Minimum Distributions: There are no Required Minimum Distribution Rules from Roth IRAs (and roll-overs from in-plan Roths) offering the potential for more significant asset growth and legacy benefits for plan beneficiaries.

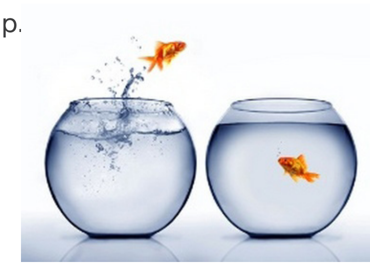
- Hedge Against Higher Future Tax Rates: Will tax rates rise in the future? Top federal tax rates rose in 2013 for taxable income above $400,000 or $450,000 for couples. If tax rates rise further in the future, a Roth may help mitigate the tax bite.

- Liquidity: Roth account's withdrawal sequencing, contributions first and then earnings, give the accounts added liquidity. Account owners can withdraw 100% of their contributions with no taxes or penalties, at any time and for any reason.

To Roth or Not to Roth

In 2010, new legislation allowed *distributable* plan savings to be converted by workers turning their traditional, pre-tax investments into a Roth in their plan through what's called an in-plan Roth conversion. This option was only permitted for plan savings eligible for distribution, assuming the plan allowed Roth contributions. Afterwards, 2012's end-of-year fiscal cliff negotiations brought about the American Taxpayer Relief Act, which contained a provision significantly expanding the plan assets eligible for a Roth conversion. Effective in 2014, this law (for which the IRS just released guidance) allows more workers to convert vested plan savings, including employer contributions, to a Roth if permitted by their plan.

Though many Roth features appear very attractive, not everyone is an ideal candidate to make these post-tax contributions, or to convert their plan savings to a Roth. For example, middle-aged and older workers who began saving late in life may fare better if they stick to traditional pre-tax savings. Late starters are unlikely to accumulate savings that would push them into in a higher tax bracket in retirement and have less time for their savings to compound tax free than younger workers do. Further, if these late savers are in one of the highest combined federal and state tax brackets, the advantages of the current income tax break may be too good to pass up.



In many situations, however, Roth usage and even conversions can be shown to be extremely advantageous. For those who can afford the tax consequences of the conversion - it may be ideal. (Conversions would not be subject to the 3.8% Medicare surtax on the net investment income.) Generally, a Roth conversion makes sense if one expects their tax rate to be the same or higher in retirement and won't need the funds for at least a decade, and preferably more.

Making the right choice between a traditional and Roth contributions is not always clear. The traditional argument for going Roth or traditional has been whether paying taxes on your retirement contributions today is better than paying taxes on your retirement savings tomorrow. But frequently changing tax rules, your current tax bracket, current and expected income, and one's retirement age are important factors in the formula that can make the analysis complex. For this reason, every individual should undertake an independent examination.

Why Washington May be Pushing

With every exemption, deduction and credit in the tax code under close scrutiny for ways to raise revenue to help slow the nation's spiraling deficit, there is mounting pressure for lawmakers to hatchet subsidies in the tax code. Among the targets frequently discussed as ripe for reform are qualified retirement plans and the deductible nature of traditional pre-tax deferrals. Critics contend that retirement plan subsidies are too generous and disproportionately benefit the wealthy. That's an odd stance especially since qualified plans are intended to be broad based by design, replete with nondiscrimination rules and limits on contributions and compensation.

Even in his recent State of the Union speech, President Obama took a jab at the tax incentives of retirement plans, encouraging Congress to "work with me to fix an upside-down tax code that gives big breaks to help the wealthy save but does little or nothing for middle-class Americans." Huh? Workplace savings accounts are about as Main Street, USA as you get! What seems lost on those in Washington is that the retirement plan tax incentives are not a permanent deduction. They are a deferral (*De·fer·ral [noun] the act of delaying or deferring something – Merriam-Webster*). A salary deferral contribution deducted today, is a dollar taxed sometime in the future (and typically a larger dollar amount). Therefore Washington actually benefits from the earnings on contributions too – making it a form of indirect government savings – imagine that!

Illustration by: Mark Matcho

It is interesting to contemplate the reasoning behind the current popularity of Roth accounts in Washington. With mounting pressure to be fiscally responsible while simultaneously addressing worker's meager retirement savings, Roth accounts highlight both. Therefore, the focus on Roth accounts is not too surprising given Washington's infamous shortsightedness. Even if this new found Roth panacea loses tax receipts in the long run, the government will reap the revenue benefit of conversions today, given that the new in-plan Roth conversion rules are estimated to raise $12.2 billion in revenue over the next 10 years.

As political pressures and lingering concerns over inadequate retirement savings mount, greater use of Roth IRAs may be an answer. As Brian Graff, Executive Director and CEO of ASPPA stated, "Given that the way Congress 'scores' the tax cost associated with retirement savings incentives is completely wrong - they ignore the fact that it's a deferral, not a deduction — the focus on Roths is not surprising." One might also conclude that this is simply another form of robbing tomorrow's taxpayer to pay for today's. If Congress can do that now, what is to prevent a future Congress from backtracking on the tax-free withdrawal of Roth earnings to generate much-needed tax revenues later?

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