

# Insight

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## *Roth 401(k)s, Roth IRAs and 2010 Roth Conversions*

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The year 2010 is important for Roth conversions for a few reasons – the elimination of income limits on conversions and the anticipated "sunset" of Bush administration tax cuts. In this article, we review key factors underlying participant decisions about Roth conversions. We begin with background on the economics of Roth 401(k)s and the Roth/non-Roth decision generally. We then discuss the 2010 changes. We close by discussing possible additional Roth conversion legislation that may affect employer plans.

We note that, [like our last article on asset allocation](#), these issues are of direct concern to participants, and we essentially write this article from the participant's point of view. It is likely that some sponsors will also be interested in addressing participant concerns with respect to this issue and, perhaps, facilitating participant decisions in some cases.

### **What is a Roth 401(k)?**

Simply, a Roth 401(k) is the same as a regular 401(k) program, except that: (1) money goes in "after-tax," and (2) money comes out tax-free. In a regular 401(k) program, money goes in pre-tax and then is taxed on distribution. [Note that a regular 401(k) program may also accept money after-tax, but throughout this article we will use "non-Roth 401(k)" to refer to a regular pre-tax 401(k)].

### **Roth 401(k) vs. non-Roth 401(k) – Similarities**

Let's begin with how Roth and non-Roth 401(k) programs are the same. Assuming constant tax rates and identical investment returns, a participant will, net of taxes, have the same amount at retirement (or over any specific period) if he or she contributes to a Roth or a non-Roth 401(k) in equivalent amounts. The phrase "equivalent amounts" here disguises a couple of tricky issues; the easiest way to illustrate what we're talking about is to work through an example.

Let's take an individual who contributes \$1,000; the individual is in a 40% tax bracket. We assume constant tax rates and investment returns of 5% per year. Under a Roth program, the participant pays taxes on the \$1,000 and then contributes the remainder – \$600 – to the plan. Under a non-Roth program, the participant pays no taxes up-front and contributes the entire \$1,000 to the plan. Here's how the numbers work out in both cases.

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### Equivalence of Roth and Non-Roth Programs

|                  | Year | Roth     | Non-Roth |
|------------------|------|----------|----------|
|                  | 0    | \$ 600   | \$ 1,000 |
|                  | 1    | 630      | 1,050    |
|                  | 2    | 662      | 1,103    |
|                  | ...  | ...      | ...      |
|                  | 15   | 1,247    | 2,079    |
| <b>Taxes</b>     |      | (\$ 0)   | (\$ 832) |
| <b>After-tax</b> |      | \$ 1,247 | \$ 1,247 |

### Assumptions

Initial contribution \$ 1,000

Investment return 5%

Tax rate 40%

So, in the end and after taxes, the payout is the same. Thus the tax benefit – Roth or non-Roth – is identical.

### What's the Difference?

Within the constraints of our example, Roth and non-Roth 401(k) programs produce the same result and are therefore “effectively equivalent” savings vehicles when tax rates are constant. But there are some key differences. Most obviously, the equivalence of result under both programs depends on our assumption of constant tax rates. If an individual is in a lower tax bracket at the time of contribution than he or she expects to be in retirement, the Roth contribution is clearly the better deal. Similarly, if an individual is in a higher tax bracket at the time of contribution than he or she expects to be in retirement, the non-Roth contribution is the better deal.

A less obvious difference has to do with the effective limit on 401(k) contributions. Tax Code limits apply on a nominal basis. As a result, individuals making Roth contributions can use the vehicle to sock away more dollars into the plan than the “effectively equivalent” non-Roth 401(k). Again, the point is most easily made with an example. The 2010 limit on 401(k) contributions (Roth or non-Roth) is \$16,500. Let's run our analysis again using that number.

|                  | Year | Roth      | Non-Roth    |
|------------------|------|-----------|-------------|
|                  | 0    | \$ 16,500 | \$ 16,500   |
|                  | 1    | 17,325    | 17,325      |
|                  | 2    | 18,191    | 18,191      |
|                  | ...  | ...       | ...         |
|                  | 15   | 34,302    | 34,302      |
| <b>Taxes</b>     |      | (\$ 0)    | (\$ 13,721) |
| <b>After-tax</b> |      | \$ 34,302 | \$ 20,581   |

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### Assumptions

Initial contribution \$16,500

Investment return 5%

Tax rate 40%

What happened? The Roth contribution was the same as the regular contribution, but the Roth contribution went in after-tax. So the amount saved was, in effect, a bigger number. To illustrate, let's expand the above example. To support the \$16,500 Roth contribution, it takes \$27,500 in pay, with 40%, or \$11,000, needed to cover taxes. If the \$16,500 was instead contributed to the non-Roth 401(k), the (current) tax bill drops to \$4,400 (and take-home pay increases \$6,600). Restated, in the Roth scenario, all \$27,500 of the pre-tax dollars are going towards providing after-tax retirement income, while just \$16,500 of the pre-tax dollars are in the non-Roth case.

### 2010 Roth Conversions

That's the background. Now let's consider a key decision that individuals are facing in 2010 – whether to convert a non-Roth IRA to a Roth IRA. Two key changes in the Tax Code make 2010 a critical year for this decision.

Prior to 2010, a non-Roth IRA could generally only be converted to a Roth IRA if the taxpayer's adjusted gross income did not exceed \$100,000. A similar income restriction applied to rollover distributions from retirement plans (e.g., a non-Roth 401(k)) to Roth IRAs. Both of these restrictions were eliminated in 2010. Additionally, the Bush tax cuts (e.g., the reduction in the highest marginal tax rate from 39.6% to 35%) are set to expire at the end of 2010.

### Qualified Plan Distribution + Roth Conversion

When you put these two changes together, it becomes clear that—from the point of view of tax efficiency—it may be in the interest of some qualified plan participants (i.e., non-Roth 401(k) participants) to take a distribution from their plan and roll it into a Roth IRA, paying taxes at 2010 rates rather than (expected) higher post-2010 rates. Under current law, to be eligible for this, the participant would need the combination of a "distributable event" that, under the Tax Code, allows a distribution from his or her qualified plan, along with plan provisions allowing distribution on that distributable event.

Here's where the plan sponsor comes in. Generally, qualified plans do not provide for distribution prior to termination of employment. But plans may provide for distribution prior to that date in certain circumstances. The Tax Code rules on what constitutes a distributable event are very complicated. We are not going to review them here, other than to note that, in certain circumstances, distributions may be made in-service to a participant who has attained age 59 1/2.

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### Possible 2010 in-the-Plan Roth Conversions

The Roth conversion process we described above involved a distribution from a plan to a Roth IRA. The American Workers, State, and Business Relief Act of 2010, which passed the Senate in March, included a provision that essentially allows the conversion of a non-Roth 401(k) account to a Roth 401(k) account, provided other requirements are met. It's not clear at this point whether the House will agree to the approach taken in the Senate bill.

In any case, there is increasing discussion among policymakers on using the "Roth approach" more widely. Why?

### Roth Congressional Budget "Magic"

One factor driving "Roth" policy is a peculiarity of the Congressional Budget Office's (CBO) budget "scoring" procedures. The CBO only looks at budget impact over the next 10 years. So, while Roth and non-Roth programs are equivalent in the real world, when this scoring window is used to calculate the cost of the budget effect of the two programs, you get very "un-equivalent" results.

Consider the cost to the budget of our \$1,000 contribution by an individual in a 40% tax bracket. Under the non-Roth approach, the individual gets a \$1,000 deduction in year 0 – cost to budget = \$400. Ultimately, in year 15, that individual will pay \$832 in taxes, but since that payment is outside the scoring window, it will not be reflected in CBO's score. Thus, the cost to revenues of the contribution (in "real" terms) is overstated.

On the other hand, under the Roth approach, the individual pays \$400 tax on the \$1,000 in year 0 – cost to budget = \$0. Ultimately, in year 15, that individual will get back \$647, of which he or she will pay no taxes (\$1,247 less the original \$600 investment) – cost to the budget (in year 15) = \$259 (40% of \$647.) But since that payment is outside the scoring window, it also will not be reflected in CBO's score. Thus, the cost to revenues of the contribution (in "real" terms) is understated.

Note also that a Roth conversion – the conversion of a non-Roth IRA to a Roth IRA – exaggerates this effect. Here, a conversion moves the revenue gain from outside-the-scoring-window to inside-the-scoring-window and, voila, tax revenues have "increased."

In "real life" – as we demonstrated above – assuming constant tax rates, the cost to the budget of both Roth and non-Roth programs is identical. The CBO scoring methodology explains the current enthusiasm for Roth programs, at least when contributions limits, etc. are being increased. Thus, we are now hearing about the possibility of legislation that is in part "financed" by provisions expanding the availability of Roth conversions.

### Conclusion

As we understand it, most sponsors are not experiencing significant participant demand for accommodation of Roth conversions. It is possible that individual 2010 tax planning has not

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yet begun; but it is also possible that concerns about the instability of tax policy (e.g., will income taxes go up, or might there be a shift to a value-added tax regime?) are preventing action. Another possibility: to do a Roth conversion, the participant must be prepared to write a big tax check in 2010; many participants will find that a stretch.

In any case, sponsors will want to consider the issues and opportunities presented by Roth 401(k)s and Roth conversions as a part of general plan design policy.

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