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**Re: Reconsidering Roth Accounts**

Dear Clients and Other Friends:

In 2006, 401(k) plans and 403(b) annuities will be allowed to offer participants the opportunity to turn some or all of their pre-tax elective deferrals into "designated Roth contributions" which – like contributions to a Roth IRA – are taxed in the year of contribution but earn tax-free income.

Few plan sponsors, though, seem to have noticed. Unlike Roth IRAs, which have been heavily marketed, Roth 401(k) and 403(b) contributions do not seem to be getting much attention, despite the fact that they are available to more highly paid employees because they are not subject to the Roth IRA income limits.

One reason is economic equivalence: if tax rates do not change, a pre-tax contribution and an equal amount reduced by tax and contributed as a designated Roth contribution produce the same wealth at retirement if they grow at the same rate.

Another reason is risk: in order to get a tax-free distribution of the earnings on designated Roth contributions, a five-year holding period must be met. If the holding period requirement is not met, economic equivalence is lost.

Finally, there is complexity: designated Roth IRA contributions must be maintained in separate accounts, but they must – except for their tax consequences – be treated like elective deferrals. They must be tested along with pre-tax elective deferrals, and they reduce dollar for dollar the amount of pre-tax contributions available to a participant.

**Why, then, might a plan sponsor offer the Roth account feature?**

Here are three reasons:

- 1. Roth accounts can accumulate greater after-tax wealth.**
- 2. Roth contributions can mitigate discrimination testing problems and allow highly compensated employees whose contributions are chronically restricted to accumulate more retirement wealth.**
- 3. Adding a Roth option gives participants a significant new choice at minimal cost to the sponsor and avoids later complaints that the sponsor prevented participants from protecting themselves against future higher tax rates.**

These reasons may not in all cases be sufficient to overcome the increased complexity associated with Roth accounts, but they do justify a second look at the Roth feature.

## I. Roth Accounts Can Build More Wealth

Designated Roth contributions are treated like pre-tax elective deferrals for purposes of the dollar limit on elective deferrals under Code §402(g). For 2006, then, participants in a plan with a Roth feature will be able to contribute up to \$15,000 of any combination of pre-tax contributions and Roth contributions. If your goal is to maximize retirement wealth and you assume stable tax rates, this actually favors Roth contributions. The reason can be best explained with a simple example:

**Pre-tax:** If \$15,000 is contributed on a pre-tax basis, grows at 7% per year for 15 years to \$41,385, and is then taxed at 25%, the net amount is \$31,039.

**“Equal Effort” Roth:** If \$15,000 is first taxed at 25%, and the after-tax amount of \$11,250 is contributed as a designated Roth contribution that grows at 7% per year for 15 years, the tax-free Roth distribution will be exactly the same (\$31,039).

**Maximum Roth:** If the participant contributes \$15,000 to a Roth account (instead of \$11,250), the \$15,000 will grow at the presumed 7% annual rate to a net amount after 15 years of \$41,385.

In the “equal effort” Roth scenario, the participant has committed the same amount of pre-tax income to retirement saving, but the participant has not used up the Code §402(g) limit. If the participant is willing and able to contribute on a Roth basis up to the 402(g) limit – in the “maximum Roth” example above, the participant would have to use \$20,000 of pre-tax income to make the \$15,000 after tax contribution – the accumulated wealth at retirement is significantly greater.

Put another way, Roth accounts effectively increase the amount of wealth that can be amassed from contributions equal to the Code §402(g) limit, even if tax rates do not rise. The §402(g) limit permits either a \$15,000 pre-tax contribution or a \$15,000 Roth contribution. As the example above shows, a \$15,000 Roth contribution can be the economic equivalent of a \$20,000 pre-tax contribution at a 25% tax rate. At higher tax rates, the equivalent pre-tax contribution would have to be even higher. (For example, at a tax rate of 33%, the economically equivalent pre-tax contribution would have to be more than \$22,000.)

Participants who have the extra income and don’t have an equally attractive non-qualified deferred compensation opportunity, then, should be interested in Roth accounts.

## II. Roth Contributions by HCEs Can Mitigate Discrimination Testing Problems

The example used in the preceding section showed that a Roth contribution of \$11,250 can be the economic equivalent of a \$15,000 pre-tax contribution (assuming a stable tax rate of 25%). These two contributions look very different though, for purposes of discrimination testing.

If the participant had testing compensation of \$150,000, the \$15,000 pre-tax contribution would result in a deferral percentage of 10%, but the “equal effort” Roth contribution would result in a deferral percentage of only 7.5%. If the plan was forced to limit contributions by highly compensated employees to 7.5%, the “equal effort” Roth contributor would be unaffected but the pre-tax contributor would lose the ability to contribute \$3,750 (i.e., 2.5% of \$150,000). Higher tax rates increase this effect. A participant in the 25% tax bracket who is limited to a 3% pre-tax contribution could make Roth contributions economically equivalent to a 4% pre-tax contribution. A participant in the 33% tax bracket could make Roth contributions economically equivalent to a 4.5% pre-tax contribution.

If discrimination testing is a limiting factor for the contributions of highly compensated employees, it appears that the negative effect of contribution limits can be mitigated if highly compensated employees make their contributions to a Roth account, rather than on a pre-tax basis.

### III. Who Should Decide?

Plans that do not offer the Roth account feature when it becomes available will be denying participants the opportunity to decide for themselves whether their future tax rates will be higher or lower. (Remember, higher future tax rates favor Roth contributions; lower future tax rates favor pre-tax contributions.)

Some commentators have argued that future tax rates really cannot be predicted, so it makes no sense to complicate plan administration just to give participants a chance to play a tax rate lottery with their retirement savings.

That seemingly reasonable position, though, fails to take into account personal differences that may affect marginal tax rates. Even if future federal tax rates cannot be predicted, so the best estimating stance is to assume stable rates, individual circumstances may allow some participants to know that their personal tax rates are more likely to be higher or lower when they retire. If an individual's odds of higher rates at distribution are better than even, it would make sense for that individual to elect Roth contributions, so long as the chances of higher rates outweigh the holding period risk.

Failing to allow Roth contributions, after all, is not a neutral posture. It assumes that future tax rates will be the same or lower. If future rates prove higher, participants (with the benefit of 20/20 hindsight) may be tempted to fault the sponsor for denying them the opportunity to avoid those higher rates. ("If only my employer had let me make Roth contributions when tax rates were low, I wouldn't be paying these higher taxes in my retirement and living on stale bread and dog food.") Such complaints may not spur litigation, since the decision whether to implement Roth accounts is clearly a design decision, and design decisions are not fiduciary acts, but they could undermine the goodwill that sponsors intend to create with their plans. For this reason, sponsors puzzling over whether to include Roth accounts may want to consider whether their long-term interests are better served if the plan prevents participants from hedging against rising tax rates, or if the plan gives participants the ability to choose. Sponsors that generally favor maximizing choice may decide to hand the decision to participants, even if the result for some participants will be worse than if the choice had not been offered. Other sponsors may just decide that simple is better.

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Proposed regulations issued in March on the testing consequences of Roth accounts have not yet been finalized, and regulations regarding the taxation of Roth distributions have not yet been issued, so there are still a variety of unanswered questions regarding Roth accounts. For example, if a Roth account feature will be implemented for 2006, must the required plan amendment be adopted in advance, or can it be adopted later?

There is enough guidance, though, to start thinking seriously about implementing a Roth feature for 2006. It is our understanding that most recordkeepers have already adapted or are in the process of adapting their systems to accommodate Roth contributions, so that should not be an obstacle. Whether the potential benefits discussed here will justify the other administrative difficulties of adding separate Roth accounts for any particular plan, though, will depend on the individual facts and circumstances.

If you would like our help in evaluating or implementing Roth accounts for your plan, or if you have any other questions about designated Roth contributions, please let us know.

Sincerely,

John W. Haine