A Tax-Side Perspective on DC Plans and DC Plan Rollovers: Rothification and Other Issues

AOA Training Conference
May 9, 2018

NATIONAL INSTITUTE ON
Retirement Security
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Agenda

- What is a Roth Account?
- What is a Roth IRA, how does it compare to a traditional IRA?
- Which is “Better”?
- What is a Roth 401(k), how does it compare to a traditional 401(k) account?
- How Popular are Roth 401(k)s?
- What is Rothification?
- Is Rothification Good or Bad?
- Conversions

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What is a Roth?

- Roth accounts are retirement savings accounts that allow money to grow tax-free.
- Participants in these plans fund them with after-tax dollars, meaning they’ve already paid taxes on the money put into the accounts.
- The money in the account grows tax free and there are no taxes paid at retirement.
- They now come in two flavors:
  - Roth IRA
  - Roth 401(k)

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What is a Roth IRA?

- Introduced by Congress in 1978.
- Form of individual retirement account (IRA)
- Allows for contributions up to $5,500, per year. If a participant is older than 50, the limit is $6,500, per year.
- Can be used in addition to a 401(k).
- No early distribution penalties after holding the account for five years.
- Not subject to required minimum distribution rules, so can be used as an estate planning vehicle.
- Not available to high earners

What is a Roth IRA?

- 2018 Roth Income Limits

If your filing status is...	And your modified AGI is...	Then you can contribute...
married filing jointly or **qualifying widow(er)**	< $189,000	up to the limit
	≥ $189,000 but < $199,000	a reduced amount
	≥ $199,000	zero
married filing separately and you lived with your spouse at any time during the year	< $10,000	a reduced amount
	≥ $10,000	zero
single, **head of household**, or **married filing separately** and you did not live with your spouse at any time during the year	< $120,000	up to the limit
	≥ $120,000 but < $135,000	a reduced amount
	≥ $135,000	zero

Traditional IRA v. Roth IRA

	Traditional IRA	Roth IRA
Contributions	MAY be tax deductible	Contributions are not tax deductible
	Cannot contribute past age 70 1/2	May contribute past 70 1/2
Earnings	Generally, earnings are tax deferred until withdrawn	Generally, earnings are tax deferred AND tax free upon withdrawal (*)
Income Requirements	No income limit to make contributions (deductibility can vary)	Adjusted Gross Income must be below certain limits
Distributions	Distributions required at 70 1/2	No requirement for distributions at any age during your lifetime

(*) - Unless certain requirements are not met, in which case taxes and penalties could apply

What is a Roth IRA?

Millions of US Households Own IRAs

	Year created	Number of US households with type of IRA,[1] 2017	Percentage of US households with type of IRA,[1] 2017
Traditional IRA	1974 (Employee Retirement Income Security Act)	35.1 million	27.8%
SEP IRA[2]	1978 (Revenue Act)	7.6 million	6.0%
SAR-SEP IRA[2]	1986 (Tax Reform Act)		
SIMPLE IRA[2]	1996 (Small Business Job Protection Act)		
Roth IRA	1997 (Taxpayer Relief Act)	24.9 million	19.7%
Any IRA[1]		43.9 million	34.8%

[1] Households may own more than one type of IRA.

[2] SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs are employer-sponsored IRAs.

Sources: Investment Company Institute Annual Mutual Fund Shareholder Tracking Survey and US Census Bureau

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Which is "Better"

	Traditional	Roth
Wages	$10	$10
20% tax due	0	$2
Amt. invested	$10	$8
Grow 10-fold		
Value at distribution	$100	$80
15% tax due	$15	0
End wealth	$85	$80

When tax rates are *lower* at distribution, end wealth is *higher* for the traditional IRA.

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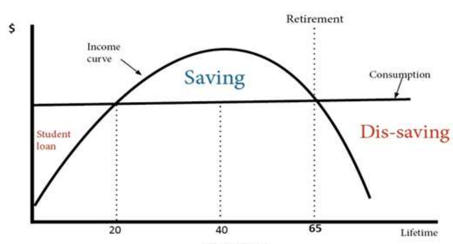
Which is "Better"



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What is a Roth 401(k)?

- Introduced by Congress in 2006.
- Employer-sponsored account that is funded after-tax.
- Though, an employer match is pre-tax.
- Allows for contributions up to $18,500, per year. If a participant is older than 50, the limit is $24,500, per year.
- Can be used in addition to a 401(k).
- Can distribute account balance after holding funds for five years, but distribution must be made on account of disability, death of an account owner, or reaching age 59 ½.
- Subject to required minimum distribution rules.
- Available to everyone, high income earners are not excluded.

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What is a Roth 401(k)?

Roth 401(k)		Traditional 401(k)	
Income	$ 50,000.00	Income	$ 50,000.00
Roth 401(k) Contributions	$ 18,000.00	Traditional 401(k)	$ 18,000.00
Taxable Income	$ 50,000.00	Taxable Income	$ 32,000.00
Federal Taxes	$ 8,238.75	Federal Taxes	$ 3,738.75
Social Security	$ 3,100.00	Social Security	$ 1,984.00
Medicare	$ 725.00	Medicare	$ 464.00
MN State Tax	$ 3,093.37	MN State Tax	$ 1,824.37
TOTAL TAX	$ 15,157.12	**TOTAL TAX**	$ 8,011.12
Take Home pay	**$16,842.88**	**Take Home pay**	**$23,988.88**
	Difference:	**$ 7,146.00**	

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How Popular are Roth 401(k)s?

- 29% of employers currently offer a Roth 401(k).
- 25% of employers are likely to add it in upcoming years.
- 7.4% of participants make Roth 401(k) contributions when available.
- Usage is highest for newly enrolled workers.
- Younger workers are more likely to use a Roth option.
- On average, Roth contributors defer a combined 10.8% of their pay into Roth.

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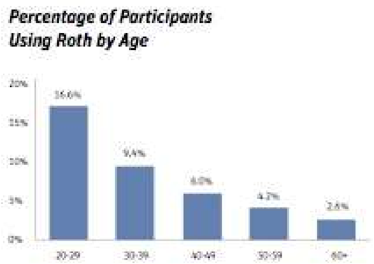
How Popular are Roth 401(k)s?



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How Popular are Roth 401(k)s?

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What is Rothification?

- Move to eliminate traditional IRA and traditional 401(k) accounts and move everything to a Roth-style account.
- Idea is to shift taxation to today, rather than to some date in the future.

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Is Rothification a Good or Bad Thing?

1. Moving to an all Roth model would greatly benefit higher-income households, not lower-to-middle income households, as these households need tax preferred retirement savings the most.
   - Roth benefits individuals who believe they will be a higher tax bracket in retirement than when they put their money into the account.

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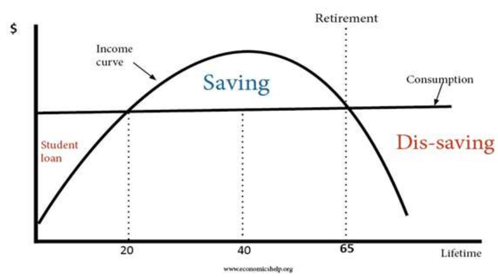
Is Rothification a Good or Bad Thing?



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Is Rothification a Good or Bad Thing?

2. According to Bill Gale of the Brookings/Urban Tax Policy Center, Roth 401(k)s complicate savings choices, induce little to no new private savings, and could actually reduce long-term national savings.
   - This is because most of the benefits of these retirement vehicles accrue to high-income and wealthy taxpayers who are able to shift existing taxable assets into tax-favored savings plans, as a form of tax sheltering.

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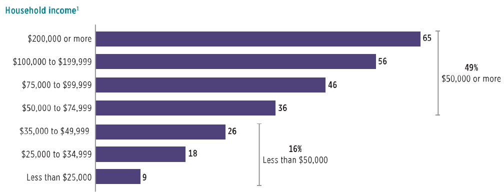
Is Rothification a Good or Bad Thing?

Incidence of IRA Ownership Increases with Household Income
Percentage of US households within each income group that own IRAs,[1, 2] 2017



[1] Total reported is household income before taxes in 2016.
[2] IRAs include traditional IRAs, Roth IRAs, and employer-sponsored IRAs (SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs).
Source: Investment Company Institute Annual Mutual Fund Shareholder Tracking Survey

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Roth Conversions

- Used to be an income cap of $100,000, but this was removed.
- Now, individuals can convert as long as they pay tax on the conversion.
- There is no withdrawal penalty if funds a converted from a traditional account to a Roth account within 60 days of the initial contribution.
- Conversions are mostly utilized as a "creative" tax planning vehicle.
- TCJA removed ability to "undo" these conversions.

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Questions?

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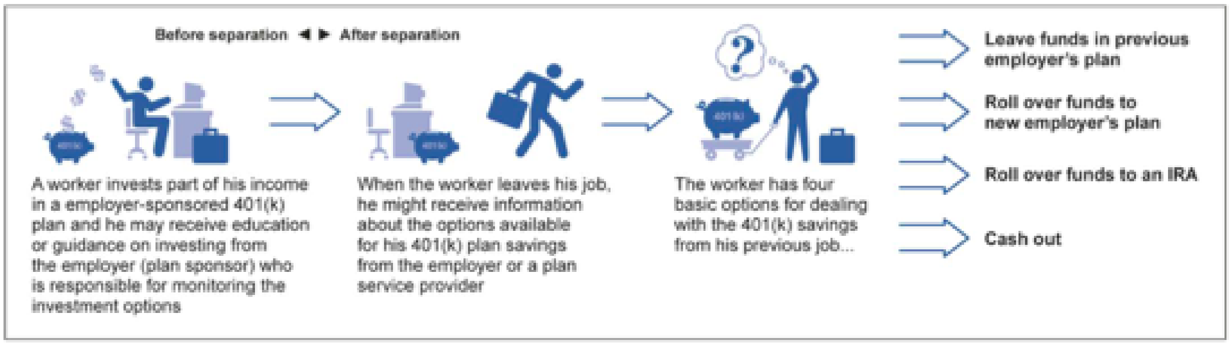
Leakage from DC Plans

Employees have four choices when they separate from an employer and they have retirement savings: leaving the funds in the old employer's plan, rolling over the funds to the new employer's plan, rolling over the funds to an Individual Retirement Account (IRA), or cashing out the funds.



Source: GAO report entitled *401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants*

The Bipartisan Policy Center has identified this fourth choice "cash-outs" from retirement plans as the most harmful form of leakage. This occurs when departing employees withdraw lump-sum distributions from retirement plans rather than leaving the money or rolling it over. Moreover, the Employee Income Security Act of 1974 (ERISA) allows private sector employers to compel employees to transfer, rollover or withdraw their DC balances at termination or separation, if their account balance is less than $5,000, which eliminates the employees' option to leave their money in the existing plan. Cash-outs are subject to a ten percent early withdrawal penalty if the employee is under age 59 ½ and 20 percent withholding for the federal income taxes that will be due on this source of income.

Additionally, many workers withdraw retirement funds without terminating employment to pay for emergency medical expenses, educational expenses, to buy a home or to meet other hardships. Such hardship withdrawals are subject to a 10% penalty tax if completed prior to age 59 ½ and a 20 percent withholding for income taxes. Still other workers who take out plan loans against their retirement accounts may not repay the loan due to default or job loss. At that time the remaining balance of the loan is subject to income taxes and a 10 percent penalty tax and contributes to retirement leakage.

"Leakage" – is a systemic issue in the U.S. retirement system and affects one out of four retirement plan participants. In 2014 alone, leakage resulted in $81 billion dollars of lost retirement savings, or an estimated 50 cents of each dollar contributed to retirement plans. The accounting and consulting firm PWC found in a 2015 survey that 35% of individuals believed that they would have to use their retirement savings to pay for non-retirement expenses. Workers who take hardship withdrawals, or cash-out their retirement plans when changing jobs, will walk away with less in their account because of early withdrawal penalties and applicable federal, state, and local income taxes. For example, a worker who withdraws $10,000 may lose up to $4,000 or 40 percent on their account because of taxes and penalties. The impact of these losses becomes even greater over time.

In addition to the immediate reduction for taxes and penalties, workers lose the benefit of tax-deferred compound interest on the withdrawn amount. Munnell and Webb estimate that leakage reduces 401(k) retirement wealth by 25 percent and individual retirement account (IRA) wealth by 23 percent.

Required Minimum Distributions (RMDs)

Required Minimum Distributions (RMDs) are one of the most complex aspects of the retirement income system for many retirement participants, particularly those with Individual Retirement Accounts (IRAs). Part of the complexity arises because the rules are inconsistent for different types of plans. Because of the complexity and inconsistency, some taxpayers make errors and are forced to pay IRS penalties, which amount to 50 percent.

IRS rules mandate that you take your first RMD by April 1 of the year following the calendar year in which you reach 70½ years of age. Usually, brokerage firms and other financial institutions that are custodians or trustees of traditional IRAs calculate or offer to calculate the RMD for IRA owners and to report this information to the IRS. Similarly, firms that serve as administrators to employer-sponsored retirement plans typically calculate this amount for plan participants. However, these requirements do not free the participant from responsibility. In fact, the Treasury Department's Inspector General has estimated more than 250,000 individuals failed to take required minimum distributions valued at $348 million in 2006 and 2007.

The required minimum distribution for a year is the account balance as of December 31 of the preceding calendar year divided by a distribution period from the IRS's Uniform Lifetime Table in 26 C.F.R. § 1.401(a)(9)-6. If your spouse is your sole beneficiary and is more than 10 years younger than you, you will use the Joint Life and Last Survivor Expectancy Table (Table II in IRS Publication 590).

The beginning date for their first required minimum distribution is determined as follows:

Type of Plan	**Required Minimum Distribution Date**
IRA (including SEP and SIMPLE IRAs)	April 1 of the year following the calendar year in which you reach age 70½
401(k), profit-sharing, 403(b), or other defined contribution plan	Generally, April 1 following the later of the calendar year in which you: reach age 70½, or retire.