STRATEGIES FOR MAXIMIZING RETIREMENT SAVINGS

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INVESTMENT PARTNERS

The Role of Roth and After-Tax Contributions

Most employers have a diverse workforce. Employees often span a wide age spectrum, fall into different income tax brackets, and have a variety of retirement savings goals. One of the benefits of a 401(k) plan is that its flexible features allow a single plan to accommodate the savings needs of a diverse workforce.

This article explores three different types of employee contributions that can be included in a 401(k) plan and illustrates how each contribution type aligns with different retirement savings objectives.

Qualified distributions from a Roth account are tax-free, both the portions attributable to contributions and to earnings. A distribution is qualified if the participant satisfies a five-year waiting period, and the distribution is taken after the participant **attains age 59½, dies,** or **becomes disabled.**

The five-year waiting period begins on the first day of the taxable year a participant makes their first designated Roth contribution and ends after five consecutive years have passed.

EMPLOYEE CONTRIBUTION OPTIONS

A 401(k) plan may permit three types of employee contributions:

1. **Pre-tax deferral** is the dominant employee contribution option in a 401(k) plan. Employees who meet the plan's eligibility requirements must be allowed to make pre-tax elective deferrals. If an employee chooses to contribute a portion of their compensation into the plan each pay period, they receive an immediate tax benefit because the contribution is excluded from taxable income. Earnings grow tax-deferred. Each distribution of pre-tax deferrals (and earnings) is included in taxable income in the year distributed.

2. **Designated Roth contribution** is a type of employee deferral that is available in a growing number of plans. Roth deferrals are made on an after-tax basis — that is, they do not reduce an employee's taxable income when contributed. Earnings grow tax-deferred. Each distribution is considered a pro rata share of contributions and earnings. The contribution portion is distributed tax-free because the tax was paid on those dollars at the time of contribution. The earnings portion is also distributed tax-free if certain requirements are met and the distribution is considered "qualified."

3. **After-tax contribution** is another employee contribution option made with after-tax dollars. Each distribution is considered a pro rata share of contributions and earnings, and only the earnings portion is included in taxable income.

The following chart provides a side-by-side comparison of additional characteristics of these three categories of employee contributions.

	Pre-Tax Deferrals	Roth Contributions	After-Tax Contributions
Contribution Taxation	• Contributions are excluded from income in contribution year (pre-tax)	• Contributions are included in income in contribution year (after-tax)	• Contributions are included in income in contribution year (after-tax)
Annual Contribution Limit	• $19,500 (for 2020), plus age-50 catch up of $6,500 (aggregated with Roth contributions)	• Same as pre-tax deferrals (aggregated with pre-tax deferrals)	• Lesser of $57,000 (for 2020) or 100% of compensation (aggregated with all other employer and employee contributions)
Nondiscrimination Testing	• Included in actual deferral percentage (ADP) test	• Included in actual deferral percentage (ADP) test	• Included in actual contribution percentage (ACP) test
Distribution Timing	• Permissible distribution triggers: > Severance from employment > Death > Disability > Attaining age 59½ > Plan termination	• Same as pre-tax deferrals	• Plans may permit distribution at any time
Distribution Taxation (Each distribution consists of a pro rata portion of contributions and earnings)	• Contributions and earnings are taxed in distribution year	• Contributions and earnings are tax-free if distribution is "qualified" • Earnings are taxable if distribution is not "qualified"	• Contributions (basis) are tax-free • Earnings are taxable

Evaluating Options

As 401(k) plan sponsors evaluate whether offering Roth or after-tax employee contribution options would be a benefit for their employees, it is helpful to understand how employees might use these contributions as part of their retirement savings strategy.

Diversify Tax Status

Increasingly, financial advisors and their clients are recognizing the importance of diversifying the tax characteristics of retirement savings. Because qualified Roth distributions are tax free and only the earnings portion of employee after-tax distributions are taxable, these types of savings can help reduce the annual amount of taxable income in retirement. In addition to potentially keeping a retiree in a lower tax bracket, this strategy can reduce the taxes owed on Social Security benefits.

The ability to diversify assets between taxable and non-taxable savings vehicles can also be beneficial for certain estate planning strategies. Individuals who want to transfer wealth with no or minimal tax impact to their heirs may value access to Roth and after-tax savings options.

Maximize Contributions

After-tax contributions may appeal to plan participants who want to maximize the amount they are contributing to the plan, especially those who are more highly compensated or nearing retirement. Because after-tax contributions are not considered employee deferrals, they are not subject to the $19,500 (for 2020) aggregated annual limit that applies to pre-tax and Roth contributions. A participant could potentially make the maximum deferral contribution, plus additional after-tax contributions. Keep in mind, however, that after-tax contributions will be included in the ACP test and are subject to the annual limit of the lesser of $57,000 (for 2020) or 100% of income.

Roth contributions may help maximize the impact of contributions by shielding earnings from taxation (for qualified distributions). For a young employee with many years to save, the ability to avoid taxation of accumulated earnings can be very appealing.

Minimize Tax Rates

For many plan participants, the decision to make pre-tax contributions versus Roth or after-tax contributions is driven by their perspective on tax rates. If they believe they are in a lower tax bracket today than when they will be withdrawing retirement assets, they may choose to pay taxes today by making Roth or after-tax contributions. An example is a young employee who is in the early stages of their career. For employees of all ages and income levels, if they believe Congress will increase tax rates in the future, they may forego the tax benefits of pre-tax deferrals on a portion of their retirement savings and opt for Roth or after-tax contributions.

A critical factor to explore when discussing employee contribution options with existing and prospective clients is how these options will impact plan administration and overall plan costs. Adding the Roth or after-tax features to a plan will require a written plan amendment. Adding flexibility to a plan also adds a certain amount of complexity. Employee education or communications explaining the new contribution options will be essential. It may be helpful to include the plan's administrative service provider and plan design expert in plan design discussions with plan sponsors.

In-Plan Roth Conversion Option

A plan that allows Roth contributions may also allow participants to convert pre-tax deferrals and employee after-tax contributions into the Roth account. Pre-tax assets and the related earnings must be included in income in the year they are converted. If after-tax employee contributions are converted, only the earnings portion would be taxable in the conversion year. The amount converted, along with future earnings or gain, would be distributed tax-free so long as the distribution is qualified. The in-plan Roth conversion option provides participants flexibility as to when they pay taxes on their 401(k) savings.

Plan Design Strategies for Success

Virtus developed this primer to help advisors incorporate plan design support as a cornerstone of their retirement plan practice. The content covers:

- The opportunity created by plan design
- Some of the plan features that have the greatest impact on participant outcomes
- A possible framework for delivering effective, scalable plan design and benchmarking support

To learn more about the retirement resources available from Virtus, visit **virtus.com/DCIO**.