

## Focus On...The Year-End, and the New Year New Law Creates Powerful Incentives for Employers to Offer a Roth 401(k) or Roth 403(b) Option to Their Existing Retirement Plans

By James Lange, CPA/JD

### The Opportunity

A brand new tax law creates a powerful incentive for employee benefits professionals, human resources professionals, and business owners to add a Roth 401(k) or a Roth 403(b) component to their existing 401(k) or 403(b) retirement plans. This article describes the new law as well as makes the case that every company or non-profit organization that currently has a 401(k) plan or a 403(b) plan should add a Roth 401(k) or a Roth 403(b) component to their existing retirement plan.

### The Small Business Jobs and Credit Act

The Small Business Jobs and Credit Act (H.R. 5297), signed by President Obama on September 27, 2010, is likely to receive more attention for its impact on small businesses than its impact on existing 401(k) and 403(b) retirement plan participants. In essence, the new law permits employees with a 401(k) or a 403(b) plan to make a Roth conversion *within their retirement plan* to a Roth 401(k) or a Roth 403(b). Yes, participants will have to recognize income in the amount of the conversion, but,

after that, their Roth 401(k) or Roth 403(b) will grow income tax-free for their lives, their spouse's lives, and potentially their children and grandchildren's lives.

A look at a somewhat simplified example will shed light on why this bill is so significant for 401(k) and 403(b) owners. Assume that Bill, who is currently employed, has one million dollars in his traditional 401(k) plan. This is Bill's only retirement plan, he does not have any money in an IRA, or any other type of plan. Under the existing rules of Bill's 401(k) plan, he does not have access to that retirement plan unless he retires or is terminated. The only way he would be able to make a large Roth IRA conversion would be to retire or quit, and roll the money from his 401(k) to an IRA and then make a Roth IRA conversion, but Bill wants to keep working.

With the passage of the Small Business Jobs and Credit Act, and if his employer chooses to offer the Roth 401(k) or Roth 403(b) option, Bill will now have a new opportunity to move into the Roth environment. Furthermore, as

of January 1, 2010, the income limits governing who could make a Roth IRA conversion were repealed. The two new laws converge to allow Bill to make a traditional 401(k) a Roth 401(k) conversion. Unfortunately, if Bill's company does not choose to offer a Roth 401(k) then Bill cannot make the conversion.

### Costs and Benefits of Roth Conversions

The issue of whether he would be better off converting his 401(k) to Roth 401(k) will depend on his and his family's personal circumstances. Whether, when, and how much Bill should consider converting has to be evaluated in terms of his current and future tax rates and the tax rates of his heirs, among other issues. A conclusion that could be drawn from reading the Roth IRA conversion literature is that it may be advantageous for Bill to convert at least a portion of his existing 401(k) to a Roth 401(k). Converting an amount as small as \$100,000, if you include the benefits to Bill's family in the

long run, could generate benefits measuring in the hundreds of thousands or even millions.

Even if it were not prudent for Bill to make a conversion, his employer would be choosing a better business strategy by offering Bill the option of making a 401(k) a Roth 401(k) conversion. Other than the relatively minor administrative cost of adding a Roth 401(k) component to an existing 401(k) plan and a little extra accounting, there is really no downside for an employer. Any employer that would like to add value to their employees retirement options without having to spend a significant amount of money should add the Roth 401(k) or Roth 403(b) components to their existing 401(k) or 403(b) retirement plan.

The employee would complete certain conversion paperwork and submit it to the plan administrator. The plan administrator would then segregate funds in the new Roth 401(k) account and would send the equivalent of a Form 1099 to the Internal Revenue Service (IRS) and the employee.

Assuming the conversion is done in calendar year 2010, the employee will be given the option to recognize the total additional income from the Roth conversion in 2010, or half in 2011 and half in 2012. Opting to recognize the income in future years is frequently the gut reaction, but sometimes, especially if income tax rates are projected to go up, it is more prudent to recognize all the income in 2010. The employees who will benefit the most by making this conversion are typically employees who can afford to pay the income tax on the conversion from money outside the 401(k) or any other retirement plan or IRA. So, in the extreme, if Bill were to make a million-dollar

conversion of his 401(k) to a Roth 401(k), the resulting additional federal income tax on the conversion would be \$350,000 (assuming a 35 percent tax rate). Unless Bill has \$350,000 outside of his retirement account to pay the taxes on the conversion, then the conversion becomes far less attractive.

What would probably be more prudent for Bill, depending on his current and future income tax rates, would be to do a series of 401(k) to Roth 401(k) conversions over a number of years. Doing a series of conversions would have two benefits. The first benefit would be that Bill would not suffer the sticker shock of writing a huge check to the IRS. The more important reason, however, is that unless Bill is already in the 35 percent bracket, the income from the conversion might actually increase his tax bracket as well as his tax. A too large conversion could push Bill into a higher tax bracket. For middle income taxpayers, planning a series of conversions, over several years, for amounts that take them to the top of (but not exceeding) their current tax bracket, or perhaps amounts that push them from the 25 percent to 28 percent bracket, would be a relatively conservative Roth 401(k) long-term plan. Of course each individual's decision should be evaluated on a case by case basis with the assistance of an experienced professional.

Over time, using reasonable assumptions, the employee maximizing his/her contribution to the Roth 401(k) is going to be better off than the employee maximizing his/her contribution to the traditional 401(k). An exception to this general rule is if a highly compensated employee is in the final years of his or her service and he or she will drop down to a much lower income tax bracket in retirement. In that case, it would most likely be more prudent for the employee to maintain investing in

the traditional 401(k) and then consider a Roth IRA conversion after they retire. But unless an employee is going to be in a lower tax bracket later on, the analysis certainly favors a Roth 401(k) over a traditional 401(k). If you think income tax rates are going up, then the Roth 401(k) becomes even more advantageous than traditional 401(k).

## Employee Retention

Many companies, including financial companies, have been extremely slow to make the Roth 401(k) or Roth 403(b) option available. One of the purposes of offering the Roth retirement plan options, in addition to being a good corporate citizen, is to retain good employees. By not offering the Roth 401(k) option, an employer may be giving its employees an incentive to find work with another company that does offer the option. Adding a Roth 401(k) or 403(b) component, especially if a company provides training for its employees, will increase, not decrease retention and help with attitude. It also demonstrates that the employer is concerned about the financial futures of its employees.

## Conclusion

Prompt employer action on this issue is important because 2010 is a particularly good year for Roth IRA or Roth 401(k) conversions. Though no one knows for sure, there is certainly a possibility that tax rates will go up in 2011, particularly for high income employees. If that is the case, it would be advantageous to make the conversion while income tax rates are lower.

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