Roth Usage in Defined Contribution Plans

April 2014

Retirement Research

Aon Hewitt, the global talent, retirement and health solutions business of Aon plc (NYSE: AON).

Offering Roth accounts within a defined contribution plan has become increasingly common and, is expected soon to become the norm—not the exception. According to Aon Hewitt's *2013 Trends & Experience in Defined Contribution Plans* report, 50% of employers currently allow employees to make Roth contributions, an increase from just 11% in 2007. This paper explores participant use of these plans; specifically:

- What percentage of participants use the Roth feature? Does the time since employer adoption matter?
- What is the profile of a typical Roth user?
- How do savings rates among Roth users compare to those of non-users?
- What steps can employers take to encourage more usage of Roth accounts?

Facts About Roth

- Employee contribution limits include both before-tax and Roth contributions—$17,500 for 2014, which is significantly higher than the Roth IRA at $5,500
- Unlike Roth IRA contributions, there are no income limits for making Roth contributions
- Plan sponsors may match Roth contributions
- Loans and certain withdrawals are permissible from Roth accounts
- Roth contributions are available for tax-free, penalty-free distributions when an individual reaches age 59½, dies or suffers a disability—but only if a Roth contribution account is at least five years old

Background on Roth

More than three-quarters of employers rely on the defined contribution plan as the primary retirement income vehicle for their workforces. Historically, these plans have encouraged participants to save on a before-tax basis. However, legislative changes in recent years have paved the way for individuals to save in a defined contribution plan via an after-tax option, the Roth account. First, the Pension Protection Act of 2006 cemented the long-term permanence of the Roth feature in 401(k) and 403(b) plans. Later, legislation in 2011 allowed governmental 457(b) plans to add Roth. Finally, the American Taxpayer Relief Act of 2012 further liberalized Roth provisions by relaxing the in-plan conversion requirements.

By contributing to a Roth account, participants are electing to trade the tax deductions available in the current year in exchange for tax-free benefits in retirement. Specifically, individuals contribute to a Roth account on an after-tax basis, and, upon retirement, these contributions and the earnings on them can be withdrawn tax-free.[1]

Whether Roth contributions are better than before-tax contributions depends on two factors: 1) the tax rate today, and 2) the tax rate in retirement. If rates are the same, there is no difference in the net benefits of the two approaches. If tax rates are **higher** in retirement, the Roth contribution is more beneficial. Conversely, if tax rates are **lower** in retirement, before-tax contributions will yield more take-home income.

A Roth in-plan conversion allows a participant to convert an existing balance of funds to a Roth account. Under this approach, participants must pay taxes on the converted balance in the year of the conversion. The decision whether or not to convert depends not only on the participant's viewpoint of the future of tax rates, but also on the availability of assets outside the plan, as any tax burden resulting from the conversion cannot be paid from the defined contribution plan balance.

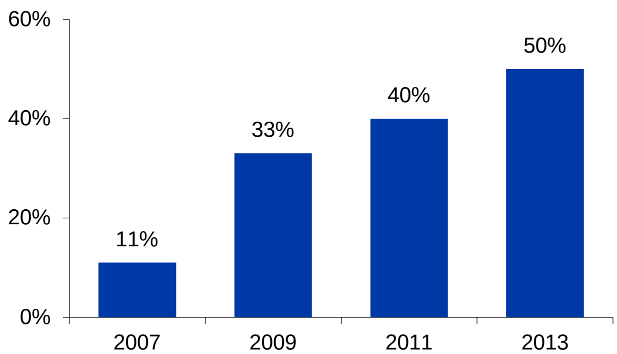
Employer Prevalence: Roth Availability is Steadily Increasing

Employers are increasingly keen on adding the Roth feature to their defined contribution plans. In the past seven years, the percentage of employers allowing individuals to contribute to a Roth account has grown nearly fivefold, and Roth is now offered by half of all qualified plans.[2] The earliest adopters of Roth were primarily financial services employers; however, Roth contributions are now prevalent across **all** industries.

Employer Adoption—Summary Facts

- 50% of employers currently allow Roth contributions, up from 11% in 2007
- 27% of plans with a Roth feature also allow Roth in-plan conversions

Roth Prevalence

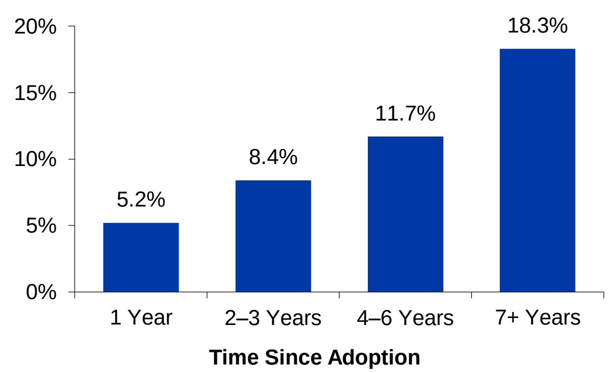


While the availability of the Roth account deferral feature has increased relatively quickly, Roth in-plan conversions are less common—but gaining momentum. As of 2013, more than one-quarter (27%) of plans with a Roth feature also allow Roth in-plan conversions. Another 66% of respondents said they are very or somewhat likely to add Roth in-plan conversions in 2013.[3]

Employee Usage: The Longer the Time Since Adoption, the Greater the Usage

Over time, Roth usage has steadily increased. In 2012, the average Roth participation rate was 8.1%—but by the beginning of 2014, 11.0% of participants were contributing money to a Roth account.[4] The usage at any particular company can be wide-ranging—from 4% to nearly 25% of participants. Most companies with low Roth participation implemented the feature only recently. Generally, in the first year after adopting Roth fewer than 6% of workers use the feature. Companies seeing the highest usage are those who were the early adopters of Roth. However, participation steadily grows the longer Roth has been offered in the plan. Among companies who have offered the Roth feature for seven or more years, the average participation rate is 18.3%, compared to 7.6% in 2006.[5]

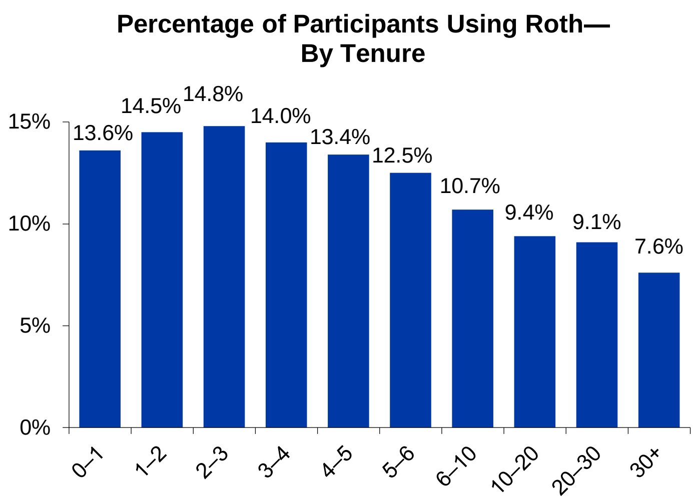
Percentage of Participants Using Roth—By Time Since Adoption

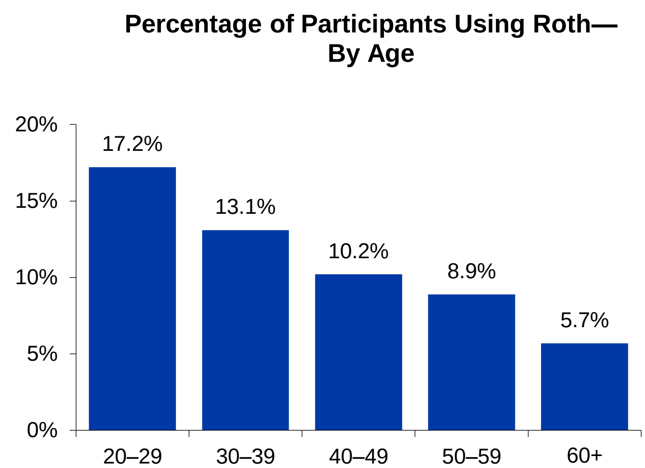


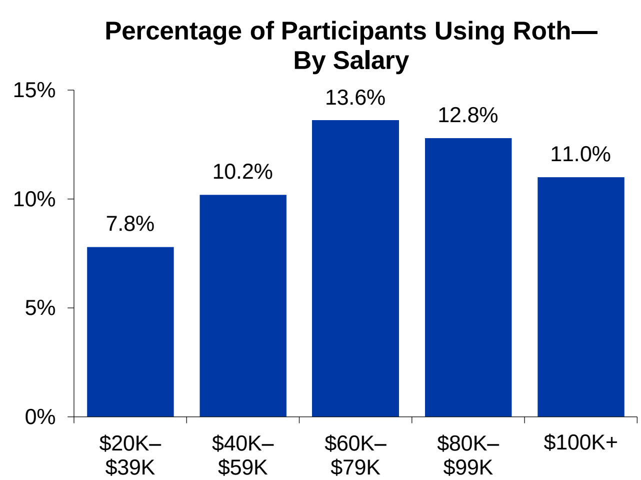
Employee Usage: New Hires, Younger Workers and Those Making $60K–$79K Most Common Roth Users

Shorter-service employees are more apt to use the Roth feature than those with longer tenure. Among participants who enrolled in the past two years, more than 14% opted to save a portion of their money in a Roth account. In addition to service, Roth usage is related to age. Younger participants are more likely to use a Roth contribution feature than their older counterparts. More than 17% of workers in their 20s elected to contribute to a Roth, versus fewer than 9% of those in their 50s. This is consistent with the premise that younger workers will benefit more from Roth contributions, given they often have lower current tax rates (typically correlated to lower wages).

In terms of salary, those earning between $60,000 and $79,000 had the highest Roth usage, at 13.6%.

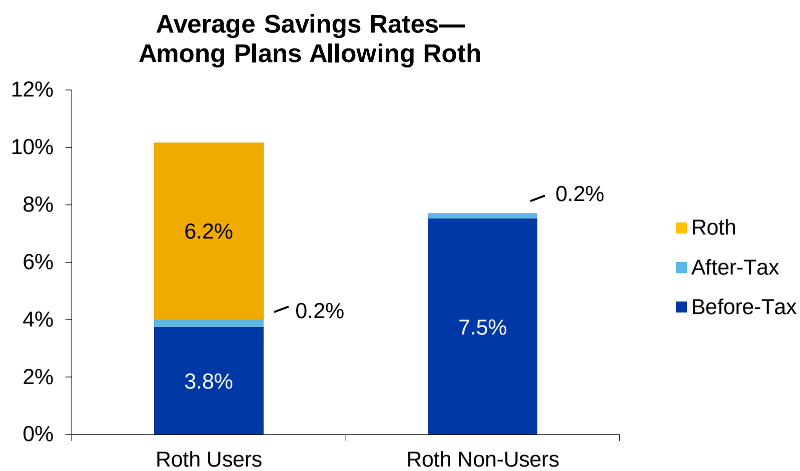






Employee Usage: Roth Users Save More

Among plans that allow Roth contributions, the average deferral rate for the Roth users (10.2%) was considerably higher than the average contribution rate of the rest of the population (7.7%).



This is particularly notable because, due to the tax implications, every dollar saved to a Roth account is worth more than a dollar saved to a before-tax account.

Consider the following simplified example comparing how retirement income differs when $5,000 is contributed to a Roth account, a before-tax account and an after-tax account for 30 years at a 7% interest.

	Roth	Before-Tax	After-Tax
Contribution	$5,000	$5,000	$5,000
Balance After 30 Years	$38,061	$38,061	$38,061
Tax Amount (25% Rate)	$0	$9,515	$8,265[6]
Ending Balance	**$38,061**	**$28,546**	**$29,796**

These results may not be surprising, since contributing a dollar today to a Roth account costs a participant more in take-home pay than contributing a dollar to a pre-tax account. The point of this example is to illustrate that a dollar contributed to a Roth account produces more retirement income than a dollar contributed to a pre-tax account. Moreover, considering the employer-matching contribution threshold has long been a common savings rate for employees—nearly one-third of all employees defer at exactly the rate of the plan's matching threshold—employees can substantially increase their take-home retirement income by changing their contributions from a before-tax basis to Roth.

Best Practices and Next Steps

It is clear that Roth prevalence is growing. More employers are **offering** the Roth feature, and more employees are **using** it. As more employers add the Roth contribution feature and/or expand the availability of in-plan conversions, there are certain best practices and actions to follow and consider:

- **Communication.** Use multiple channels (email, postal mail, employee newsletters, workshops, etc.) to communicate with employees on the Roth features.
- **Education.** Teach participants about Roth contributions and conversions:
  - Provide a comparison of Roth and before-tax contributions
  - Share examples of who should consider making Roth contributions
  - Explain the benefit of tax diversification
  - Discuss the pros and cons of converting existing before-tax and after-tax balances to Roth
  - Provide modeling tools to help employees make educated savings decisions
  - Address frequently asked questions about Roth
- **Automation.** Consider the impact of automation defaults and discuss whether setting a Roth account as a default is appropriate.

Contact Information

Rob Austin, FSA, EA
Director of Retirement Research
Aon Hewitt
+1.704.347.0100
rob.austin@aonhewitt.com

About Aon Hewitt

Aon Hewitt empowers organizations and individuals to secure a better future through innovative talent, retirement and health solutions. We advise, design and execute a wide range of solutions that enable clients to cultivate talent to drive organizational and personal performance and growth, navigate retirement risk while providing new levels of financial security, and redefine health solutions for greater choice, affordability and wellness. Aon Hewitt is the global leader in human resource solutions, with over 30,000 professionals in 90 countries serving more than 20,000 clients worldwide. For more information on Aon Hewitt, please visit www.aonhewitt.com.

[1] Tax-free withdrawals are available only if the Roth account is at least five years old and the individual is at least age 59½, dies or suffers a disability.
[2] *2014 Trends & Experience in Defined Contribution Plans Survey*, Aon Hewitt, 2014.
[3] *Ibid.*
[4] These calculations are performed across active participants, where Roth is available. Whereas 8.1% of active participants save via Roth, that becomes 5.8% usage when assessed across eligible employees.
[5] *How Workers Are Using the Roth 401(k),* Aon Hewitt, 2006.
[6] For purposes of simplicity, this example assumes the 25% tax is paid on the investment earnings which equal the ending balance ($38,061) minus the initial contribution of $5,000. In reality, the tax situation could be much more complicated.