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THE UPCOMING 401(k) DILEMMA

By Allen Buckley

Beginning in 2006, with respect to 401(k) plans that so provide, participants will be allowed to elect to treat their 401(k) deferrals as Roth after-tax contributions. Thus, many individuals will need to decide whether to continue the traditional 401(k) route of tax deferral or pay taxes currently in exchange for complete exemption from taxation upon distribution at retirement.

In statutory form, 401(k) plans have been permitted since 1978. The popularity of these plans grew incredibly during the 1990s. Today, the 401(k) plan is the predominant tax-qualified deferred compensation plan.

Roth IRAs are a relatively recent phenomenon. Internal Revenue Code Section 408A was added in 1997 to specifically allow after-tax (Roth) IRA contributions that grow tax-free and then permit the owner to withdraw the contributions plus earnings free of all federal tax.

After-tax contributions to 401(k) plans have been permitted for years. Typically, these contributions have been called “thrift” contributions. While thrift contributions may be withdrawn tax-free, any earnings on thrift contributions are subject to income tax upon distribution. In contrast, a future Roth 401(k) distribution (i.e. including earnings) made in accordance with Code Section 402A and after attainment of age 59.5 will be completely free of tax. (Generally, in order for Roth treatment to apply to a distribution, the distribution must be made after the end of the 5-taxable year period beginning with the taxable year of the first Roth election under the 401(k) plan.)

Contributions to a 401(k) plan are called “elective deferrals.” Currently, they reduce an employee’s taxable income (W-2) for the year. Similarly, a self-employed individual’s 401(k) contributions are tax-deductible for income tax purposes. However, elective deferrals by employees and self-employed persons are subject to FICA (Social Security and Medicare) tax.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) added Code Section 402A, to be effective in taxable years beginning after 2005. Section 402A permits the Roth election with respect to a 401(k) elective deferral. By making a Roth 401(k) election, an employee’s contributions for the year will be subject to both income and FICA tax.

On March 2, 2005, the Treasury Department issued proposed regulations relating to the new Roth 401(k) option. Probably most significant is a provision of the regulations that states that the Roth/traditional decision must be made at the time the election to defer is made. The election to defer must be made before the compensation is payable. Accordingly, for plans that will permit Roth 401(k) contributions on January 1, 2006, systems will need to be put in place by January 1, 2006, and participants will need to make their initial decisions in January of 2006 or prior thereto. Separate accounting of Roth accounts will be necessary. Plan sponsors of 401(k) plans are not required to amend their plans to allow participants to make Roth elections. The question is: Should a sponsor amend its plan to permit Roth deferrals?

Until very recently, significant tax rate bracket differences have usually existed for any given tax year. Thus, executives have utilized “nonqualified” elective deferral plans, so as to defer compensation (plus earnings) until retirement, when they presumably would be subject to tax at a lower rate. However, the brackets have been compressed and the rates lowered in recent years, thus reducing the tax benefits of a traditional nonqualified elective deferral plan. (The highest tax bracket is now 35 percent, and it applies to taxable income in excess of $319,100.) If the tax laws don't change (an unlikely assumption), the foregoing changes will impact non-executives who defer compensation through a 401(k) plan in a similar manner.

For plans that will allow Roth elective deferrals, the question for plan participants soon will be: traditional 401(k) elective deferral or Roth after-tax elective deferral? What the right decision is for any individual will depend on a number of unknown factors, including the future investment returns of the deferrals, the future inflation rate, the future personal income and expense expectations of the employee and the future tax system of the U.S. An assumption can be made that the investment returns and the inflation rate will be the same under either choice. Thus, the decision will likely need to turn on the individual's personal income and expense expectations and the future tax system of the U.S.

Few people can estimate their future income stream at retirement. People who have worked in the same position for many years and who don't expect to make any significant career moves are in the best position to guesstimate their future income from non-401(k) sources at retirement. In this regard, the older the person is, the greater the person's likelihood of being able to correctly estimate non-401(k) sources of income. In contrast, a professional person who is young and tends to change positions relatively frequently will have a relatively difficult time estimating future retirement income from non-401(k) sources. Even those individuals who can predict their non-401(k) plan income stream at retirement with a reasonable degree of comfort will have a difficult time budgeting for future expenses. In this regard, no one knows exactly what the future holds.

Consider the current financial situation of the U.S. and its implication to future retirees. The debts and the present value of the unfunded liabilities of the U.S. government now total approximately $42 Trillion, which breaks down to about $330,000 per full-time worker. The Bush Administration has recently proposed to attempt to solve Social Security's problems. However, in the Medicare Modernization Act of 2003, Congress greatly expanded Medicare by adding Part D, relating to prescription drugs. (The cost of new Part D has been estimated to cost more than double the entire cost of fixing Social Security.) In order for the country to survive and flourish economically, it is almost certain that Medicare's benefits will need to be cut. If Medicare benefits are cut, seniors will be required to pay for more of their medical costs. Professional asset managers believe that the financial problems of the government, including the existing debts that are held by Far East banks and other creditors, are now holding back the stock market. Thus, it appears that seniors can have their Medicare with diminished market returns or take Medicare reductions and look for better market returns to help them pay their medical bills.

The financial problems of the U.S. government lead to the second variable factor in the pre-tax/post-tax decision: the future tax system of the U.S. Net of Social Security's surplus, the deficit for the fiscal year ended September 30, 2004 was $413 Billion. Without Social Security, the deficit was over $560 Billion, and it exceeded fifty percent (50%) of the total non-Social Security federal tax revenue. The dollar has been losing value as of late due to the accumulated budget deficit and the trade deficit. Something has to give. But what?

The Bush Administration recently announced plans to revamp the U.S. tax system in a "revenue neutral" manner. A committee has been formed to analyze current problems and propose solutions. Thus, any changes can be anticipated to produce the same amount of revenue as the current system. (Absent spending cuts, the same annual deficits will exist.) Some proposals that have been floated include the possibility of a national sales tax (i.e. the "Fair Tax") to replace (or possibly supplement) the current income tax system. The question then becomes: How does one make a Roth/traditional 401(k) decision when: (a) the tax system could be greatly modified in the future; and (b) if the tax system is not greatly modified, greater tax rates are likely because of the massive deficits situation?

All other things equal, due to the time value of money, it is better to defer paying tax. But, how can anyone make a logical choice, given the foregoing considerations?

If a national sales tax was implemented in the future to completely replace the current tax system (an unlikely result, given that the Joint Committee on Taxation has said that a tax rate of almost 60% would be necessary to be revenue neutral), then those persons electing the traditional 401(k) pre-tax treatment would come out ahead, unless some sort of tax equalizer was added to benefit persons who had previously elected Roth 401(k) treatment. Great political pressure would likely exist to create such an equalizer.

What if a national sales tax was adopted in addition to the income tax (thus making the U.S. tax system similar to the Canadian system)? Would income tax rates be decreased in the future? If so, by how much? Would the reduction be enough to justify making a traditional 401(k) deferral? If the income tax is retained, will the budgetary pressures and the weakness of the dollar necessitate an across the board increase in tax rates? If so, the Roth 401(k) option becomes more appealing.

No one expects certainty in tax laws, as it is a given that they are always changing. However, in the past, when making projections for clients, CPAs have been able to "run the numbers" utilizing the tax laws in effect at the time of the analysis. This traditional assumption (i.e. that the tax laws will remain constant since no one can tell what the future holds) can no longer be applied as a reasonable assumption. The problem is: No one knows what should be assumed in its place.

It appears that no sponsor could be faulted for not allowing Roth deferrals under the current circumstances. Of course, the issue of whether to amend a 401(k) plan to allow Roth deferrals would be a settlor function that should not be challengeable. Market conditions (i.e. what competing employers are doing and cost) will impact whether employers will offer them.

One can only hope that the national debate on tax law changes is completed relatively soon. However, given the fireworks surrounding Social Security, it very likely is wishful thinking to anticipate significant federal tax changes within a couple of years.

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