AFTER-TAX CONTRIBUTIONS

Many retirement plan advisors have read articles or heard about great opportunities in using after-tax contributions in a 401k plan. There are many good reasons to allow for these contributions. This review looks at the following:

- Defining after-tax contributions
- Reviewing their history
- Identifying the opportunities
- Considering the limitations
- Determining the best way to analyze these for inclusion in 401k plans

Definition

After-tax contributions in an employer-sponsored qualified retirement plan are non-deductible contributions an eligible employee makes to their employer's plan. The earnings grow tax-deferred until they are withdrawn. The earnings are taxable, unless rolled into an IRA, and the after-tax contributions themselves are not taxed further. Plans may allow for after-tax contributions to be withdrawn at any time. They may also apply a matching formula to them.

History

Long before Internal Revenue Code 401(k) was written, many large employer qualified defined contribution plans allowed for after-tax (non-deductible) contributions. These were often matched with employer contributions. Until the 1986 Tax Reform Act, a participant could withdraw their contributions, but leave their earnings in the plan to grow tax-deferred. After TRA, the participant had to withdraw any earnings applicable to post-1986 contributions. However, the participant could roll the earnings over to an IRA and make personal use of the after-tax contributions (basis) without tax or penalty.

These "legacy" contributions remained in many plans throughout the 80s and 90s. After TRA of 1986, deferral limits were greatly lowered and capped with slow increases. This made after-contributions attractive for strong savers who were limited by lower pre-tax deferral limits. However, with the Taxpayer Relief Act of 1997, individuals had the ability to contribution to a Roth IRA. Why have tax-deferred earnings when you can have tax-free? Furthermore, with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) deferral limits began increasing much quicker than wages and Catch-Up Contributions were introduced. Finally, in 2006 Roth 401k Contributions were allowed. Since tax-free earnings trumps tax-deferred earnings, many participants felt that there was no reason to make after-tax contributions. The result was that these types of contributions were removed or never added to 401k plans.

Opportunities

After EGTRRA a number of events have changed people's view of their place and safety in the world:

- 9/11 and the War on Terror (starting in 2001)
- Great Recession and slow recovery (starting in 2008)
- Wage stagnation (continuing from the 1970s)
- Increasing political strife and disagreement (increased greatly post-9/11)
- Pandemic starting in 2020

These difficulties have led plan participants to seek any way to provide for their security. This is an opportunity for you to aid participants, increase the strength of the plan, and show your value to your clients.

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Here are the most common reasons to consider after-tax contributions:

- Additional qualified savings opportunity for those who have maximized their pre-tax deferrals and/or Roth contributions. These are the second income savers or those who are doing their best to maximize their retirement savings to the extent possible.
- "Rothification" – ability to rollover after-tax contributions and their earnings into a Roth IRA. Upon rollover, the earnings change from tax-deferred to tax-free!
- Emergency savings – participants can utilize after-tax contributions for special circumstances. These could be for the purchase of a car, home, repairs, illness, unemployment, or any other unique situation. This can actually benefit their retirement savings by preventing the need for a loan or taxable withdrawal.
- Additional savings – participants can save for Christmas, vacation, or other planned expenses. Later we will come back to this type of usage with a warning.

Here are the reasons for savings after-tax in a qualified plan:

- Very high limit to the amount participants can save – much greater than in a non-deductible IRA
- Protected from creditors
- Dollar cost averaging
- Payroll deducted
- Part of a plan in which they are already saving and investing

Limitations

As with all things in a qualified plan, the IRS has limits in place to prevent discrimination. Here are the limits and pitfalls to allowing after-tax contributions:

- Average Contribution Percentage (ACP) Test – after-tax contributions are tested like a discretionary employer match to determine if the amount of contributions to the Highly Compensated Employees (HCE) is too high compared to the Non-Highly Compensated Employees (NHCE). Unfortunately, there is no Safe Harbor contribution that applies to avoid this test. Therefore, without NHCEs saving after-tax, HCEs cannot save after-tax. The likelihood of very many NHCEs having maxed out their pre-tax deferrals and Roth means that very few, if any, will save after-tax.
- Contributions of all types to a qualified plan are to be done as a means of saving for retirement. This means that the intent and design of the plan should follow the spirit of Code section 401 which allows for defined contribution plans.
- Participant Comprehension – qualified plans are complex to most participants. They have pre-tax deferrals, Roth contributions, Roth IRAs, a number of other savings options, and now after-tax contributions are added to the mix. Communication and clear explanation as to why they are beneficial is critical to successful implementation and usage.
- Plan Sponsor Reluctance – many sponsors do not wish to add yet another payroll complexity or make another plan design change unless there is high demand for it from their participants. Since many participants will not know of the benefits possible, they will never demand it. This places the burden of proof on us, the service providers, to show the benefits and efficacy of including them.

Analysis

As is always the case, knowing the needs and wants of the sponsor and participants is critical. A solid plan should be in place to not just describe to them the benefits hypothetically, but to show them practically how the inclusion of after-tax contributions is to their betterment.

This will not always be the case for every sponsor. These are a great fit for some clients and a poor one for others.

It is important to assess the attitude the sponsor has toward the plan, the reason for the plan's existence, the type of participants, and what the potential outcome would be. To aid with this analysis, we have included three examples of hypothetical clients and the assessment of after-tax contributions for them.

Example 1

ABC Company is a manufacturing company. Their products are common, and they are successful by being low-cost and producing a high volume. Their workforce does not require much experience, so the wages they pay are lower than the average person's. Their employees are predominantly young with a high school or little college education. They also have problems with high debt, inability to save for a home, and limited ability to afford health insurance or even pay the premium on their employer's medical plan. The plan allows everyone to save and they offer a 50% match to 6% contributed. After instituting automatic enrollment at 6%, the participants became very engaged in the plan and over 80% remained contributing. They have high turnover and most all participants cash-out their account leading to taxation and penalties. They do not have a Safe Harbor contribution, so the HCEs cannot defer as much as they would like.

This type of analysis generally can be done by understanding the sponsor and participants without asking too many additional questions. Simply knowing them can lead to a determination.

In this case the inclusion of after-tax contributions would not be of benefit for the following reasons:

- Employees are saving at a high level already given their wages.
- HCEs cannot even save pre-tax or Roth as high as they would like.
- Most employees will need money at a moment's notice and will not be able to wait for the time necessary to withdraw after-tax contributions from their account.
- The ability for most employees to grasp a higher level of financial knowledge will be difficult.

Example 2

XYZ Company is a life sciences firm. They provide scientific research and data analysis to companies in the healthcare industry. Their success is found in high-level consultation that is necessary for the success of their clients. Their workforce is very experienced and credentialed. The wages they must offer are significantly higher than the average person's. Their employees are predominantly middle-aged with a at least a Master's degree. The company pays for their health insurance and their employees are able to afford an above-average to high-end lifestyle with discretionary income remaining. The plan allows everyone to save and they offer a Safe Harbor Mach of 100% match to 4% contributed. They also provide profit sharing that generally averages 5% of pay. Without automatic enrollment, plan participation is nearly 100% and the average deferral rate is 10%. Half of all employees have reached the deferral limit. They have low turnover and most terminated employees keep their money in the plan.

In this case the inclusion of after-tax contributions would be of benefit for the following reasons:

- Employees are capped on deferrals and probably are not eligible for Roth IRAs.
- The average wage of the participants is high enough that NCHEs can save after-tax with their discretionary income.

- The workforce is financially savvy enough to grasp the concept of saving after-tax to rollover into a Roth IRA to "convert" tax-deferred earnings to tax-free.
- They have a long-term mindset that allows them to be patient and not cash-out or take an action that would thwart their goals.
- Any usage of after-tax contributions would be part of a long-term and well thought out goal which means they could be patient to allow for the withdrawal from the plan to be completed.
- The sponsor wishes to make certain their employees have the best opportunities available. They may even wish to use automatic enrollment on the after-tax contributions.

Example 3

Assume a company that is a combination of the two above. In such a case with high-end services, low-end products, and employees that cover all types, after-tax contributions would not be beneficial due to testing constraints. The NHCEs would not be able to save causing the HCEs to not be able to save.

Example 4

Assume a company that is more "middle of the road." They have a middle-class workforce without a large number of highly skilled/educated employees, nor those with lesser skills/education. This is an example of a company in which after-tax contributions can work, if the sponsor is willing. After-tax contributions can be used as a vehicle to encourage a savings mindset. Some participants may wish to use them for emergencies, some as a savings account, while others plan to save until retirement and/or rollover to a Roth IRA annually.

Hopefully, the above examples give you an idea of what to look at and how to determine whether after-tax contributions are a good fit. There is no list of questions to ask. You must know your client and their employees. That will tell you whether after-tax contributions could work.

Do not use after-tax contributions or any plan feature as a "one size fits all" approach. That is never appropriate. Besides, it makes your ability to specialize your approach a commodity. Selling it as a possible feature is great. Making it a part of every plan will not go well if it is not right for the sponsor and the participants.

If you want to know more or want MVP to help in an analysis of your client, just call Mark Vaughn at (919) 612-5101 or Kelly Musico Gay at (919) 623-0219. You can also email us at mark.vaughn@mvp401k.com and kelly.musicogay@mvp401k.com.