December 2017

ROTHIFICATION

A STEP BACKWARD FOR RETIREMENT SECURITY

As tax reform was heavily debated in the fall of 2017, Congress considered altering the rules on retirement plans to further limit contributions to tax-deferred plans in favor of after-tax Roth-style plans, a change known as "Rothification." This was an effort to generate higher tax collection in the near term and offset revenue lost to corporate and personal income tax reductions. While each chamber removed the changes before voting, this concept is likely to live on in future tax policy debates. For this reason, LPL Financial decided to gauge advisor sentiment on such a proposal.

WHAT WAS ON THE TABLE

A survey was conducted with

135

LPL financial advisors who manage more than 1,600 small-business 401(k) plans with more than $5 billion in assets. Their feedback indicates that many believe that Rothification would harm the retirement security of small-business employees.

Full Rothification would mean that individuals would no longer be permitted to make pre-tax contributions to an IRA or to any type of plan (e.g., 401(k) plan, SIMPLE IRA, 403(b) plan). All individual contributions to any plan or IRA would be made on an after-tax Roth basis, with earnings distributed tax-free if Roth conditions are satisfied. Employer contributions would continue to be made on a pre-tax basis.

A partial Rothification proposal was also on the table, under which an individual would be permitted to make pre-tax plan contributions up to a maximum of approximately $2,500.

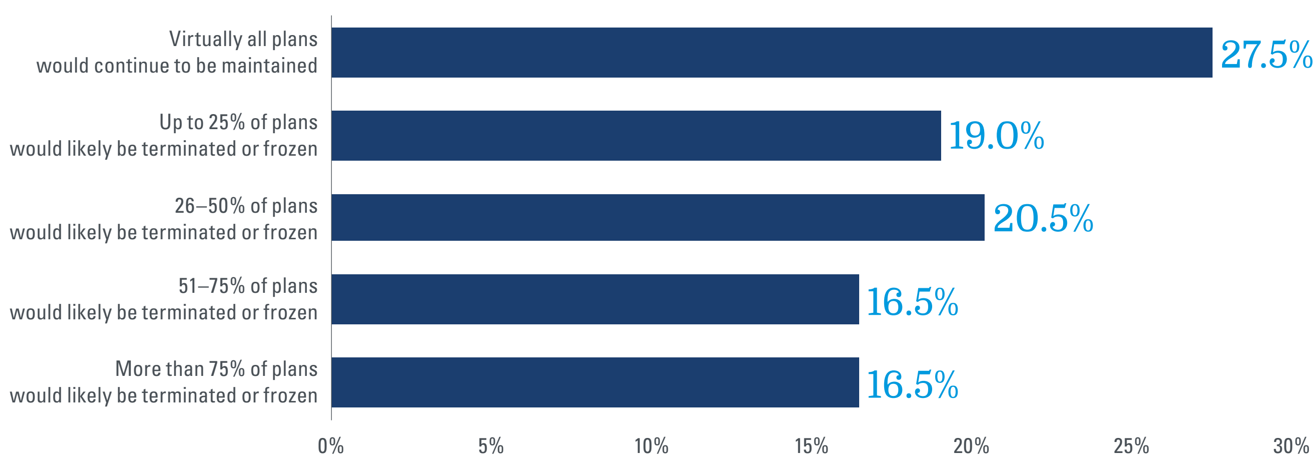
Against this backdrop, we reached out to 135 LPL financial advisors who specialize in helping small businesses manage retirement plans. These advisors, in aggregate, manage more than 1,600 401(k) plans with more than $5 billion in assets under management, putting them in a strong position to understand the implications Rothification could have for the retirement savings of small-business employees and owners.

SIZING UP THE POTENTIAL IMPACT TO SMALL BUSINESSES

>50% of advisors believe that a quarter (25%) or more of existing small-business plans would be shut down under Rothification.

Our study sought to better understand the implications Rothification legislation may have on the ability of small businesses to offer retirement savings plans, as well as how it would impact employee savings. We found that the ability to make pre-tax contributions to retirement plans is an incentive that encourages small businesses to adopt and maintain retirement plans. For example, only 27% of the advisors we surveyed indicated that they expected all of the plans they manage would continue to be maintained if contributions were converted to an after-tax Roth basis. In addition, 16% of advisors thought more than 75% of the plans under their care would likely be terminated or frozen, with the rest believing at least some plans would be impacted. Several advisors mentioned that if the upfront tax incentives these plans currently enjoy were to be removed, small-business owners would likely believe the risk and cost that these plans carry would render them not worth maintaining. We believe that this observation alone is very disturbing to today's retirement plan landscape, in which it is reported that not nearly enough small businesses maintain plans. If just 25% of existing small-business plans were to terminate, that could be devastating, and the survey showed that over 50% of advisors believe that a quarter (25%) or more of existing small-business plans would be shut down under Rothification.

Based on your experience, what percentage of small businesses (<100 employees) do you estimate would choose to maintain their plans under Rothification?



Source: LPL Rothification Survey, November 2017

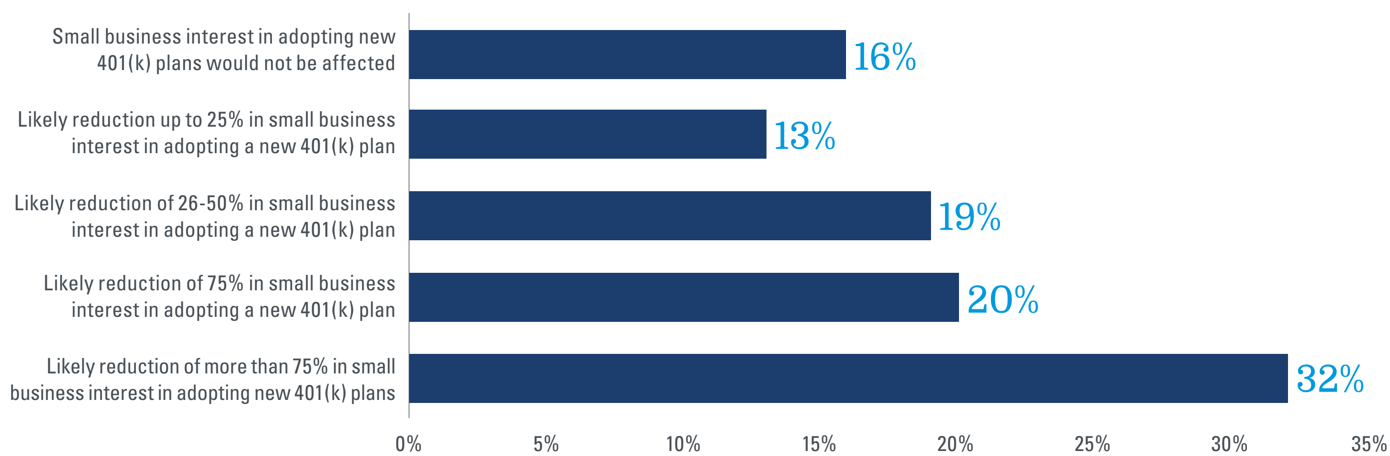
48%
of the American labor force are employed by small businesses.

While it's true that small-business employees would have other post-tax options for savings, research has shown that employees are much more likely to save, and save more, when they are automatically enrolled in an employer-sponsored retirement plan[1] (see our recently released research paper, *The Small Business Retirement Savings Challenge*, for more on this topic). If small businesses were to freeze or terminate their existing retirement plans, it could have a serious impact on the retirement prospects for the approximately 48% of the American labor force who are employed by small businesses (according to 2015 Census data).

FUTURE OPPORTUNITY FOR PLAN GROWTH

Another question focused on the potential impact Rothification could have on the establishment of new plans. The majority of advisors surveyed expect that Rothification would mean less interest in retirement plans from small businesses, with one advisor summarizing the argument as follows: "The cost of plan administration, the increased uncertainty of meaningful participation (which is already of current concern when [employees] can make pre-tax contributions), and the rising litigation risk that is more prevalent in employer-sponsored plans makes the likelihood of any small business starting a new 401(k) plan very unlikely, in my opinion."

How likely is Rothification to impact the number of small businesses that would set up new 401(k) plans with you in the future?



Source: LPL Rothification Survey, November 2017

[1] Benartzi, S., and R. H. Thaler. "Behavioral Economics and the Retirement Savings Crisis." Science 339, no. 6124 (2013): 1152-153.

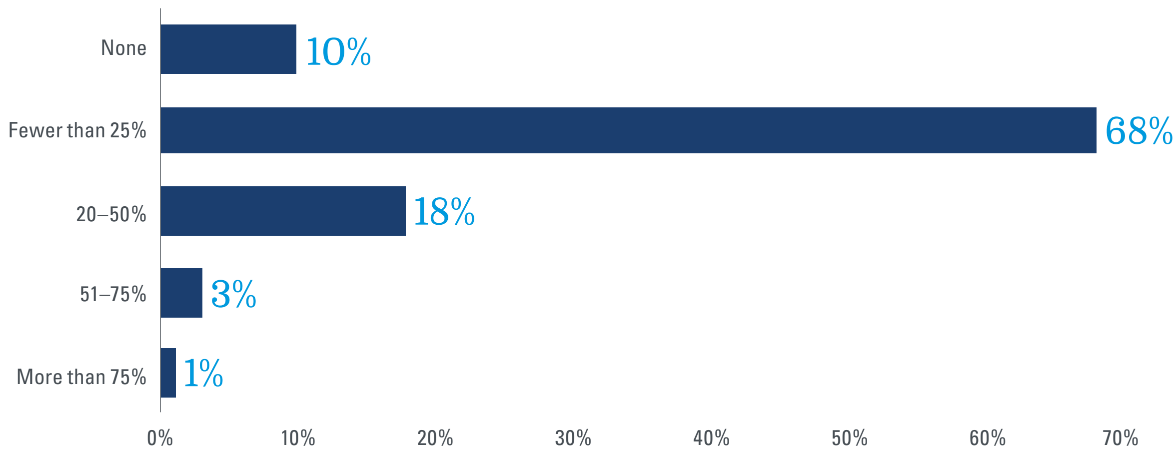
68%

of advisors indicated that less than 25% of employees make Roth contributions in their plans.

THE ROTH REALITY

The final question in our survey asked what percentage of small-business employees (excluding owners and executives) currently make Roth contributions in plans where they are allowed. The responses showed a clear pattern—68% of advisors indicated that less than 25% of employees make Roth contributions, and another 10% said that no employees used this method. This plan preference further reinforces the point that tax deferral is an important incentive that helps small-business employees save for retirement.

Thinking of the 401(k) plans with which you work that permit Roth contributions, roughly what percentage of small-business employees (excluding owners and executives) make Roth contributions?



Source: LPL Rothification Survey, November 2017

CONCLUSION

We conclude that the findings of this study and our small business retirement savings research from June 2017 clearly show that retirement security remains a major issue for Americans, and now is not the time to cut incentives to save. It appears that leaders in Washington, D.C., have come to the same conclusion as well, as Rothification was not included in the final tax reform bill passed by both chambers of Congress in December 2017. However, we believe that ideas such as Rothification will live on in future policy debates. Given all of this, we urge our policymakers to take the findings of this survey to heart and to remain committed to preserving the incentives that will help American investors save for their retirement. ■

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