AFTER-TAX CONTRIBUTIONS

To after-tax or not after-tax—that is the question. **By Jason Brown & Theresa Conti**

We have all gotten that call from a client, financial advisor or CPA—the one where they just learned about this new hidden gem of a plan design option called voluntary after-tax contributions and they need the option added to their plan immediately. While they're not commonly used today, one of us co-authoring this column remembers when many plans incorporated after-tax contributions because the retirement plan limits were low and Roth contributions didn't exist yet.

This money source has garnered much attention recently, which has created heightened interest. However, most articles don't explain how it functions from a plan operational perspective and which entities might be good potential candidates for its adoption. With that in mind, we will explore many of the items that are not typically covered to paint a fuller picture of the strategic advantages and potential hurdles associated with after-tax contributions.

THE STRATEGY

You may be wondering why after-tax contributions are currently getting so much attention from companies, as well as the government, considering that the idea has been around for decades. Most viewed this money source as a non-factor once plan limits were increased and Roth deferrals were permitted about 20 years ago; however, there are some unique characteristics that have brought it back into the spotlight.

The most common reason today that plan sponsors are considering after-tax contributions is that it can be utilized as a conduit that allows participants to "super-fund" what many in the industry refer to as a Backdoor Roth IRA. Offering this capability is a pretty big deal for individuals who cannot contribute

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to Roth IRA accounts due to AGI restrictions, especially those who want to save more than the 402(g) deferral limit. The after-tax dollars contributed to the plan can be withdrawn at any point, as long as that's addressed in the plan document. Remember that unlike Roth earnings, after-tax contribution earnings are taxable, so the cost basis is rolled to a Roth IRA, and gains are typically rolled to a traditional IRA to avoid immediate taxation. However, the participant may also pay taxes on the investment returns and deposit them into the Roth IRA. Once these dollars are rolled to a Roth IRA account, they will grow tax-deferred and are distributed tax-free (even the earnings) once account qualifiers are met.

A secondary benefit of this money source is that it provides flexibility to business owners on how they can max out their accounts, especially for business owners who receive income via W-2 and company distributions. In many cases, business owners may not want to increase their W-2 pay to maximize profit-sharing to reach the Section 415 limit due to the additional payroll taxes it would create. Incorporating after-tax contributions in conjunction with profit-sharing could help them get to the 415 limit without increasing their tax liability.

The key advantages of after-tax contributions include:

- allowing participants to save more for retirement;
- providing the option of funding a Roth IRA regardless of income;
- integrating a higher level of personal tax strategy; and
- contribution flexibility for some business owners.

THE CONUNDRUM

After hearing all the potential benefits above, you may be asking yourself, "Why doesn't every plan take advantage of incorporating voluntary after-tax contributions in its design?" It appears to be an excellent opportunity for any highly compensated employee (HCE) looking to save more for retirement, especially those who cannot contribute to a Roth IRA due to Adjusted Gross Income (AGI) phase-out restrictions. However, there are some misconceptions on how contributing to this money source can impact a retirement plan. The primary confusion is centralized on how the money is categorized and classified for compliance testing.

Many are under the impression that since the participant elects to contribute this money from their compensation, it is treated similarly to deferrals. While that makes sense on a fundamental basis, though, it is not the case. This money source is treated as a match for testing purposes, which means it is included in the Actual Contribution Percentage (ACP) testing. In most situations, HCEs are the only participants who make the after-tax contribution, which causes a more than permissible overweighting of ACP percentage for the HCEs. In many cases, this will cause the ACP test to fail, and the HCEs will get those dollars refunded. There are two common rebuttals when explaining the above circumstance to advisors and CPAs, discussed below.

The first position usually taken is that the plan is Safe Harbor Match/ Safe Harbor Non-elective, so it automatically passes ACP testing. This argument would seem to make sense on the surface; however, the additional ACP created by after-tax dollars is not insulated from a failed test result. Once this fact is disclosed, the most common response, the participant will simply roll the failed testing refund into an IRA. Again, this initially sounds plausible; however, failed testing refunds are not rollover-eligible.

Other considerations for this money source are that it counts towards the maximum plan contribution limit under Section 415. If an employer wants to maximize tax-deductible contributions through profit-sharing or a match, then incorporating after-tax contributions could impair that objective and should be evaluated.

Four key hurdles are:

1. Safe Harbor contributions do not give you ACP testing immunity for this money source;
2. failed testing refunds can't be rolled to an IRA;
3. after-tax dollars are included in the 415 limit (not in addition to it); and
4. unlike in a Roth IRA, investment gains are taxable.

THE OPPORTUNITIES

Now that we have covered some of the primary strategic concepts and prospective hurdles that come with after-tax contributions, the question becomes: who might be an ideal candidate? One of the biggest obstacles to having this money source work is passing ACP testing. This leads us to the following plan scenarios that can help mitigate that issue.

Here are the top potential candidates:

- ***Owner only/individual 401(k) plans.*** These plans have only HCEs, so there are no issues passing ACP testing.
- ***Companies that have only HCEs.*** Again, there are no non-HCEs for ACP testing.
- ***Companies that utilize the Top 20% Rule for HCE designation.*** This provision can push some HCEs into the non-HCE class for testing. If those individuals contribute, it helps ACP testing results and could also help offset after-tax contributions made by other HCEs.
- ***Large companies.*** A volume consideration as a contribution made by a few HCEs averaged over many HCEs might not affect the ACP testing significantly enough to cause a failure.

CONCLUSION

As you can see, some interesting variables come into play when evaluating the impact of after-tax contributions, and this design feature is not a "one size fits all" option for plan sponsors. However, if you do your homework and take the time to understand the goals and dynamics of a company, you might be able to find a client that can take advantage of this unique money source. PC