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Hidden Potential in Your 401(k)

401(k) savings plans have become the staple of retirement savings for the majority of Americans. As the defined benefit pension plan (in which an employee's pension payments are calculated by their length of employment and salary at the time of retirement) decreased in popularity with employers, they were largely replaced by another product, the 401(k) defined contribution plan. The merits of each program aside, it is evident that a significant shift has occurred in retirement strategy, one that puts the savings burden on the employee rather than the employer. With the burden shifted to you, the employee, the question begs:

Are you fully maximizing the potential of your 401(k) plan?

401(k) plans are relatively simple in structure. To participate, the employee chooses to defer a portion of their regular pay (usually expressed as a %) for future retirement, and the employer deposits this money into a savings plan for investment. With the exception of Roth-style deferrals, most 401(k) savings are "pre-tax," which means contributions are taken out before they are taxed as income. The tax liability is not dismissed, only deferred until retirement. At that time, any funds withdrawn from the account are taxed as ordinary income.

During the work years, some employers contribute to their employees' 401(k) savings by providing a matching contribution. 401(k) matching contributions are considered part of an employee's overall compensation and can be a significant boost to a lifetime of savings. For example, if John voluntarily defers 6% of his salary into his corporation's 401(k) savings plan, the company may pledge to match 50% of each dollar for a total of 3% match. Over a career, the additional contribution combined with employee deferral can grow to a large sum.

Many people who currently participate in their company 401(k) would consider this the end of the discussion. Sign up for the 401(k)? Check. Contribute enough money to maximize the company match? Check. But stopping here would mean missing an opportunity to take full advantage of this savings strategy's potential. And it has a lot of potential.

Contribution limits define potential annual savings

Most 401(k) plans have two contributions limits: the employee deferral limit and the overall contribution limit. Employees can defer up to $19,500 each year to a pre-tax or Roth 401(k)[1]. Employees over the age of 50 can defer an additional $6,500 catch up contribution for a total of $26,000. These deferrals can be entirely pre-tax, fully Roth 401(k) or any combination of the two, but the total cannot exceed the employee deferral limit.

The second limit is on the overall annual contribution. This includes the previous category of employee deferrals (pre-tax or Roth) plus any company matching contributions, company profit sharing, other discretionary company contributions, and

[1] Employees must have earned income equal to or exceeding this amount. Deferrals are limited to the lesser of earned income or $19,500 per year plus $6,500 catch up for over age 50 (2020). Deferral limits are *per person* even if covered by more than one 401(k) plan.

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after-tax deferrals by the employee (if available). The total annual contribution limit is $57,000 for anyone under age 50 or $63,500 for employees who qualify for the catch up contribution.[2]

Total contributions are per year and cannot be carried forward. You must use to the limit, or lose it.

The hidden potential most often overlooked - if you can use it

Most 401(k) participants never even come close to the total annual contribution limits. This occurs for a variety of reasons: The employee may not have all options available in her 401(k); she may elect to prioritize other savings/investing opportunities; she may be unaware of the plan's existence or how to participate in it; or she may decline or limit participation because the family household budget will not accommodate extra savings. In this paper, we concern ourselves with the last three groups, those who can and would benefit from after-tax savings but are not currently participating or maximizing the opportunity.

> Consider Ted, age 47. Ted feels good because he is fully funding his 401(k) salary deferral limit of $19,500 per year. In addition, Ted's employer makes a generous matching contribution of 6% of his $125,000 salary, which totals an additional $7,500. Between those two sources, Ted is saving $27,000 each year in his 401(k) plan. Though Ted is doing well to accomplish these savings, the maximum contribution limit of $57,000 means Ted is missing out on another $30,000 in tax-advantaged savings potential ($57,000 total limit - $27,000 utilized).
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> Assuming Ted has the financial means to contribute another after-tax $30,000 from his budget once other spending and savings priorities are fulfilled, how would he accomplish this goal and what are the advantages of doing so within a company-sponsored 401(k)? As mentioned above, not everyone has the same opportunity to participate in this particular after-tax strategy, and several circumstances must align in order for Ted to do so.
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> First, Ted's 401(k) must have an after-tax savings option built into the plan. This first step is a make-it or break-it one, because although after-tax savings plans are growing in popularity, this provision is not available in everyone's 401(k) plan. Second, Ted's 401(k) plan must have enough participation, and generally be large enough so that significant after-tax savings made by the highest paid employees of the company are not viewed as discriminatory to lower paid employees. Otherwise said, an after-tax savings opportunity cannot excessively benefit only the higher paid employees. For this reason, many small company plans are not able to offer after-tax savings.
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> Finally, Ted must have the desire and ability to defer additional pay into the after-tax "bucket" of the savings plan. While saving for retirement always seems like a good idea at first blush, paying down debt, contributing to 529 education plans, or making other investments may reap a larger reward over time.

I meet the criteria. How does after-tax savings work?

After-tax savings in a 401(k) plan is accomplished with an additional salary deferral deposited to the investment account after computing taxes. At year end, this deferred pay will be included on the employee's W2 as current income, unlike pre-tax contributions which are listed separately. The 401(k) plan itself is tasked with separately tracking all pre-and/or post-tax contributions.

[2] Defined contribution plan (415(c)(1)(A)) limit is $57,000 per year in (2020). Additional catch-up contribution of $6,500 per year (2020).

Earnings on after-tax contributions grow tax-deferred while in the plan. When the time comes to withdraw funds from the plan, the original contribution won't be taxed again (it has already been taxed and has "cost basis") though the earnings will be taxed as ordinary income.

After-tax contributions also do not count toward the annual deferral limit of $19,000, which is intended for pre-tax or Roth 401(k) contributions. Instead, it counts toward the second bucket which also includes company matches and profit sharing.

Why after-tax savings?

Retirement savings in tax-advantaged plans is limited. This is particularly evident for higher income earners who are restricted in ways to save. Though the tax benefits are not as enticing as traditional or Roth 401(k) savings, after-tax savings do provide an additional way to save and achieve tax deferred growth. Roth 401(k) deferrals, unlike after-tax contributions, grow tax-free while inside the 401(k) plan. In contrast, after-tax 401(k) deferrals left in the plan are subject to tax on all growth at the time of withdrawal.

As an example Sam, age 54, earns a salary of $375,000 and also participates in his company's 401(k) plan. The company matches 4% of Sam's pay up to the first $285,000.[3] Sam is already maximizing his pre-tax deferrals for a total of $26,000 (including the catch up contribution), and his company match adds another $11,400 ($285,000 x 4%). Since Sam wants to retire at age 58, he is saving aggressively and wants to participate in after-tax savings in addition to pre-tax. To fully maximize the annual limit to the 401(k) plan, Sam can defer up to $26,100 of his pay to the after-tax savings bucket. After examining his budget, he decides to save an extra $2,000 per month for a total $24,000 this year.

Investing is not without risk and favorable outcomes are never a guarantee. If the imagined investor, Sam, employs this strategy for the next four years until retirement and saves $96,000 in after-tax contributions, based upon SYM's investment beliefs and assuming 6% growth, its value at retirement may grow to an estimated $108,737.[4]

Sam is already happy with his additional savings and if he does nothing more, the $108,737 should continue to grow tax-deferred during retirement. Assuming he leaves the money in the 401(k) until he is required to take distributions at age 70.5, during those 12 years the account may grow to a value of $218,800. Of this amount, $96,000 is after-tax contributions and $122,800 is tax-deferred earnings. Upon withdrawal, only the earnings are taxable to Sam[5].

So far, this saving strategy is looking good for Sam, but he knows of a way to get an even better outcome.

Sweetening the deal

Sam's SYM advisor informed him of a 2014 change to IRS rules[6] that allowed for favorable rollover treatment of his pretax savings and after-tax 401(k) contributions. So upon retirement, Sam decided to roll his entire 401(k) over to IRAs.

Under the new rules, Sam and his advisor can allocate rollover withdrawals in the way that best benefits him. In this case, Sam chose to roll pre-tax contributions, pre-tax earnings, and earnings on after-tax contributions over to a traditional IRA where they would remain tax-deferred. After-tax contributions (cost basis), however, were rolled over to a Roth IRA. Once in

[3] Defined contribution plan covered compensation limit is $285,000 per year in 2020.
[4] $2,000 monthly savings for 48 months at 6% rate of return.
[5] Withdrawals are prorated between contributions (basis) and earnings.
[6] IRS Notice 2014-54

the Roth IRA, the after-tax money would begin to grow tax free, as long as withdrawals from the Roth IRA remained qualified. [7]

Let's look at the numbers to see how this decision affected the hypothetical Sam. Sam's pre-tax money moved to a similar account with the same tax treatment. However, when he chose to roll $96,000 in after-tax contributions (basis only, no earnings) to a Roth IRA, a once taxable account began growing tax-free. If Sam had not completed the rollover and kept the money in his 401(k) plan indefinitely, that same growth would have been taxed as regular income upon qualified withdrawal.

Based on several assumptions, when Sam reaches age 70.5[8], the balance of his $96,000 Roth IRA may have grown to $193,170. In addition, he still has the earnings from four years of pre-retirement, pre-rollover savings which were valued at $12,737 and continued to grow tax-deferred in the traditional IRA to a potential value of $25,630 (pre-tax).

The table below illustrates the total impact of the Roth IRA rollover.

	Cost Basis	Tax-deferred Earnings	Tax-free Earnings[9]	Total
Pre-retirement savings (4 years)	$96,000	$12,737	n/a	$108,737
At Age 70.5				
401(k) Account	$96,000	$122,800	n/a	$218,800 (pre-tax)
Net after-tax (30% rate)	$96,000	$85,960	n/a	$181,960 (after-tax)
IRA and Roth IRA rollover accounts	$96,000	$25,630	$97,170	$218,800 (pre-tax)
Net after-tax (30% rate)	$96,000	$17,941	$97,170	$211,110 (after-tax)

16% increase

By effectively utilizing the all favorable Roth IRA rollover rules, Sam was able to potentially increase his net after-tax spending money by 16%[10]. Since 2014, this strategy has renewed the interest in after-tax savings within 401(k) plans, and stands to be of particular benefit to high-income employees.

This same scenario also applies to an employee who leaves a workplace prior to retirement. In fact, the favorable rollover rules apply upon any separation from employment. Because this strategy is even more effective the longer time after-tax savings are able to grow in a Roth IRA, any employee with a 401(k) from a previous employer should quickly take note.

Add a superpower: more benefits to the Roth IRA rollover

To this point, we've discussed rollover options available to retirees or to people who underwent a job transition. However, some 401(k) plans with after-tax savings also allow current employees to complete in-service transfers of after-tax money at set intervals. This additional special treatment gives even more power to after-tax contributions, since an employee can defer pay to after-tax savings and then move the contribution (cost basis) to the Roth IRA much sooner than waiting for separation from the company or retirement.

[7] Qualified Roth IRA withdrawals require the Roth IRA to be open for five years and the participant to have reached the age of 59.5.

[8] Prior to 2020, required minimum distributions began at age 70.5. Beginning in 2020, RMDs start at age 72.

[9] Cost Basis and Tax-Free Earnings represent the total balance of the Roth IRA account.

[10] Net after-tax amount and percentage increase will depend on individual marginal tax rates.

Consider Betty, age 40. Betty's company 401(k) plan does offer after-tax savings, and she plans to fully utilize them until her anticipated retirement at age 60. Betty earns a salary of $375,000 and the company offers a 4% company 401(k) match. Betty is already maximizing the pre-tax savings and will also save an additional $25,500 using the after-tax portion of the plan. As a bonus, Betty's 401(k) plan allows for annual in-service withdrawals, limited to her after-tax balance, before age 60. Let's consider the impact of this added superpower on Betty.

Betty can maximize the after-tax opportunity and roll over the savings to a Roth IRA account each year. To do this, when taking an in-service withdrawal Betty must also take any earnings associated with the after-tax bucket. Betty plans to roll over the earnings too, resulting in a small amount of taxable income as the earnings are annually "converted" from the tax-deferred 401(k) to her Roth IRA.

One benefit of working with a financial advisor is the advisor's ability to project forward, then look back to see potential results. Although there are no guarantees of favorable results, this illustrative example is based upon on SYM's best understanding of savings products, tax restrictions, the power of compound interest, and how they work together. We apply those investment theories here with Betty, in a hypothetical retrospect.

Had Betty invested based on the description above, assuming a 6% rate of return she may have had the following, favorable outcome:

- Betty makes contributions of $25,500 per year for a total of $510,000 in after-tax savings.
- She completes a rollover of the after-tax balance at the end of each year.
- After 20 years, at age 60 Betty's Roth IRA balance may be $969,084. ***Tax free***.
- Along the way, some of the earnings converted to the Roth IRA are likely to result in tax payments totaling $5,908; a minor cost to potentially achieve a tax-free account value approaching $1 million.
- This account balance will continue to grow tax free during Betty's retirement and the Roth IRA has no required minimum distributions at age 72. If the growth rate continues after retirement, she could have $1,735,000 at age 70 and the balance would be 100% tax free.

When to take full advantage (even if cash flow does not allow)

As we have seen, after-tax 401(k) savings and its subsequent rollover opportunity to a Roth IRA are beneficial instruments in the retirement savings tool box. But what if you just don't have enough free cash flow to maximize this opportunity each year?

If you have other cash savings or a non-qualified investment account, consider deferring salary to maximize the after-tax savings potential and then withdrawing money from your savings or investment account to meet your cash flow needs. The opportunity is so valuable that it warrants a reallocation of current savings to make it work.

In conclusion

After-tax savings via your company 401(k) plan offers a significant additional savings opportunity when available. Recent changes to IRS rules have renewed interest in this strategy by improving the benefits, making it a top choice over other savings vehicles. However, not everyone can participate and certain criteria must be met. When all of the required circumstances align, however, after-tax 401(k) strategies make for a truly unique opportunity for high income earners to save money in a tax-advantaged way. Remember the following:

- Your 401(k) plan must allow for “after-tax savings”, not just Roth deferrals.
- After-tax savings are to be used only after completing pre-tax deferrals to your 401(k) and company matching contribution.
- Check with your company about in-service withdrawal rules for after-tax money. Some companies may have limitations on how often you withdraw after-tax money or they may restrict future savings.
- Generally, you can’t fund an after-tax 401(k) with a lump sum deposit to the 401(k) account; it still must be deferred through your pay. Start early in the year to minimize cash flow burden.
- Work closely with your advisor to ensure all parts of the strategy are implemented properly.
- This savings strategy is considered by many to be a “loop hole” in the tax code that benefits high income earners. It may not always be available but it’s an attractive strategy to use, even if it can only be used for a short time.
- Finally, this is a use-it or lose-it strategy. Savings opportunities not seized in one calendar year may not be carried over to the next.

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