June 16, 2021

Roth 457 / Deferred Compensation Plan Option

INITIAL CONSIDERATION

By Jacob White

Senior Research & Policy Manager

360-586-2327

jacob.white@leoff.wa.gov

ISSUE STATEMENT

LEOFF 2 members requested a Roth 457 Plan option in the State's Deferred Compensation Plan.

OVERVIEW

The State's Deferred Compensation Plan (DCP) is a tax qualified 457 plan and allows members to make pre-tax deferrals. Some 457 plans allow members to make deferrals after taxes have been paid. These after-tax contributions are call "Roth" contributions. Roth contributions to a 457 plan, along with investment returns on those contributions, are not taxed when a member withdraws them from the plan, so long as the withdrawal is a qualified distribution. The Department of Retirement Systems (DRS) does not include a Roth option in its DCP plans.

BACKGROUND AND POLICY ISSUES

Roth contributions to a 457 plan are made on an after-tax basis and will not reduce a member's income taxes for the year. However, Roth contributions and their associated earnings can be withdrawn tax-free if the requirements for a qualified distribution are met. The earnings from Roth contributions not being taxed is a particularly significant benefit to younger members enrolled in DCP, whose contributions accumulate earnings tax free for a much longer time.

DRS is the Plan Administrator for DCP

DRS is the plan administrator for DCP.[1] As the plan administrator DRS has the authority to implement a Roth option for DCP without legislation. In 20123 the LEOFF Plan 2 Board sent a

[1] RCW 41.50.770, https://app.leg.wa.gov/RCW/default.aspx?cite=41.50.770

letter (see Appendix A) to DRS requesting that they implement a Roth option within its Deferred Compensation Program.

Beginning in 2015, DRS presented to the LEOFF Plan 2 Board their intent to implement a Roth option for DCP as part of DRS's strategic planning goals.[2] Initially, DRS cited the implementation of a new DCP Record Keeper as the reason for the delay in providing a Roth option. Since that initial delay, DRS has changed DCP Record Keepers a second time. DRS has indicated they are not going to spend the resources to implement a Roth 457 option at this time.

Pre-Tax and Roth Contributions are not "stackable"

457 plan contribution limits apply to the combination of pre-tax and Roth contributions. For 2020 and 2021, a member under 50 can contribute up to $19,500 to their 457 plans. A member over 50 can make an additional $6,500 in catch-up contributions. Roth 457 contributions are not separate from pre-tax 457 contributions for purposes of determining the maximum annual contributions a member can make. Therefore, a member could decide what portion of their maximum 457 contribution amount ($19,500 and $6,500 in catch-up contributions) is pre-tax, post-tax, or a combination of both.

In contrast, Roth IRA contribution limits are separate from 457 plan contribution limits. A 457 plan member could make their maximum 457 contributions ($19,500 and $6,500 in catch-up contributions) and make additional contributions to a Roth IRA ($6,000 regular and $1,000 catch-up contributions).

LEOFF 2 Participation in DCP

Local employers must opt into DCP. However, many LEOFF 2 employers do not offer DCP. There have been bills proposed in prior legislative sessions requiring all public employers to offer DCP to their employees, yet none have passed. Currently, 18.90% (3,521) of LEOFF 2 members are enrolled in DCP. So far, 67% (354) of LEOFF 2 employers are enrolled into DCP. 40% of LEOFF 2 members at these 354 employers are enrolled in DCP.

Differences between a Roth IRA and a Roth 457

There is often confusion between a Roth Individual Retirement Account (Roth IRA), and a Roth 457 Plan. Both a Roth IRA and a Roth 457 Plan allow for deferrals after taxes have been paid. However, a Roth 457 Plan can only be offered by states, local governments, and certain not profit organizations to their employees. Any worker can contribute to a Roth IRA if their

[2] https://leoff.wa.gov/sites/default/files/2020-02/111815.4_DRS.Update.pdf

compensation and modified adjusted gross income fall below certain limits.[3] A Roth IRA cannot be offered through a public employer, instead an employee can set up a Roth IRA through a private investment company or bank. An employee eligible for a Roth 457 Plan may also make deferrals into a Roth IRA.

SUPPORTING INFORMATION

Appendix A: LEOFF 2 Board Letter to DRS, January 8, 2014.

[3] Publication 590-A (2020), Contributions to Individual Retirement Arrangements (IRAs) | Internal Revenue Service (irs.gov), https://www.irs.gov/publications/p590a#idm140656789740128

STATE OF WASHINGTON
LAW ENFORCEMENT OFFICERS' AND FIRE FIGHTERS'
PLAN 2 RETIREMENT BOARD
P.O. Box 40918 - Olympia, Washington 98504-0918 - (360) 586-2320 - FAX (360) 586-2329

January 8, 2014

Marcie Frost, Director
Department of Retirement Systems (DRS)
PO Box 48380
Olympia, WA 98504-8380

Dear Ms. Frost:

We share an interest in helping employees utilize retirement savings options available under federal tax law. I am writing on behalf of the Board to ask DRS to take advantage of recent changes in the Small Business Protection act of 2010 expanding those options.

The LEOFF Plan 2 Board recently reviewed information on recent changes allowing DRS's governmental 457 plans to authorize:

- Roth or after-tax contributions; and
- Conversion of current pre-tax account balances to a Roth account taxable in year of conversion.

Based on the understanding that no enabling legislation is required, the Board voted at its December 18, 2013 meeting to ask DRS to implement these Roth options.

At the request of the Board, please consider developing an implementation plan for offering this option. Thank you for your attention to this issue.

Sincerely,

Kelly L Fox

Kelly Fox, Chair
LEOFF Plan 2 Retirement System Board

Cc: Steve Nelsen, LEOFF Plan 2 Retirement Board
Jane Sakson, Office of Financial Management
Dave Nelsen, Department of Retirement Systems

Roth 457/Deferred Compensation Option

Initial Consideration
June 16, 2021

Issue

LEOFF 2 members requested a Roth 457 Plan option in the State's Deferred Compensation Plan

What is a Roth 457 Plan?

- 457 Plans may allow for deferrals to be made after taxes have been paid
- These after-tax contributions are call "Roth" contributions
- Roth contributions to a 457 Plan, along with investment returns on those contributions, are not taxed when a member withdraws them from the plan
- The earnings from Roth contributions not being taxed is a particularly significant benefit to younger members enrolled in DCP, whose contributions would accumulate earnings tax free for a longer time

Roth IRA vs Roth 457 Plan

- Roth IRA
  - A private option, doesn’t matter who your employer is
  - Workers who earn under a certain amount can contribute
- Roth 457 Plan
  - Can only be offered by states, local governments, and certain not profit organizations to their employees
  - No income limit to make contributions

Why is a Roth option not currently available in DCP?

- DRS is the plan administrator for DCP
- DRS has the authority to implement a Roth option for DCP without legislation
- In January 2014, LEOFF 2 Board sent a letter to DRS requesting that they offer a Roth option for DCP
- DRS presented to the LEOFF 2 Board multiple times their intent to implement a Roth option for DCP
- DRS has since determined they are not going to spend the resources to implement a Roth 457 Plan option at this time

457 Plan Contribution Limits

- 457 Plan contribution limits apply to the combination of pre-tax and Roth contributions
- For 2021, a member under age 50 can contribute up to $19,500 and a member over age 50 can make an additional $6,500 in catch-up contributions

LEOFF 2 Employer/Member DCP Data

- Local employers must opt into the State's DCP program
- 67% (354) LEOFF 2 employers are enrolled
- 40% of LEOFF 2 members at these 354 employers are enrolled
- 18.90% (3,521) of all LEOFF 2 members are currently enrolled

Thank You

Jacob White

Senior Research & Policy Manager

(360) 586-2327

jacob.white@leoff.wa.gov