



November 17, 2021

Roth 457 / Deferred Compensation Plan Option

COMPREHENSIVE REPORT

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ISSUE STATEMENT

LEOFF Plan 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 called "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 However, Roth contributions and their associated earnings can be withdrawn tax-free if the requirements for a qualified distribution are met.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 2014 the LEOFF Plan 2 Board sent a letter (see Appendix A) to DRS requesting they implement a Roth option within its DCP.

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 changed DCP Record Keepers a second time. Prior to the LEOFF Plan 2 Board's June 2021 meeting, DRS told the Board they were not going to spend the resources to implement a Roth 457 option at this time.

In July, the Select Committee on Pension Policy (SCPP) received a "Deferred Compensation Overview" briefing from DRS, which included information about why DRS was not offering a Roth option. DRS cited the costs associated with implementation, approximately \$640,000, as the main driver for not offering a Roth option (see appendix B). Without legislative funding the costs would be paid by all DCP participants through increased administrative fees, not just those utilizing the Roth option.

Based on the feedback from the LEOFF Plan 2 Board, SCPP, and DRS members, DRS submitted a budget request package to the Governor's Office on September 13, 2021 (see Appendix C). The budget request package identified total implementation costs as \$988,430 total over the next two biennia (\$609,350 in 2021-23 and \$379,080 in 2023-2025). DRS will find out if their budget request was approved when the Governor's Budget is released on December 21, 2021.

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 non-profit organizations to their employees. Any worker can contribute to a Roth IRA if their 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.

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

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

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

An employee eligible for a Roth 457 Plan may also make deferrals into a Roth IRA. Additionally, Roth 457 plans have higher contribution limits than a Roth IRA. Therefore, while LEOFF Plan 2 members may be able to realize post-tax savings in a private Roth IRA, they cannot save additional post-tax funds in a Roth account without their employer offering a Roth 457 plan.

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 age 50 can contribute up to \$19,500 to their 457 plans. A member over age 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 Plan 2 Participation in DCP

Local employers must opt into DCP for their LEOFF Plan 2 members to have the option of participating in DCP. Many LEOFF Plan 2 employers have not opted into DCP. Legislation requiring all public employers to offer DCP to their employees has been unsuccessful in prior sessions, however, the LEOFF Plan 2 Board has not sponsored these bills.

Currently, 18.90% (3,521) of LEOFF Plan 2 members are enrolled in DCP and 67% (354) of LEOFF Plan 2 employers are enrolled into DCP. Of those 354 employers, 40% of their LEOFF Plan 2 members are enrolled in DCP. Based on data from other state plans offering a Roth 457 option, DRS expects approximately 12% of DCP participants, or 423 LEOFF Plan 2 members, to utilize a Roth option.

POLICY OPTIONS

Option 1: No action at this time

The Board may choose to not pursue legislation this session since DRS has submitted a Budget Request with the Governor's Office. The Board will not know whether the Budget Request was included in the Governor's Budget until after the final interim meeting in December.

Option 2: Endorse legislation

The Board may sponsor legislation this session in case DRS's Budget Request is not included in the Governor's Budget or is cut from the final budget passed by the legislature.

SUPPORTING INFORMATION

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

Appendix B: DRS Presentation to SCPP, July 2021.

Appendix C: DRS Budget Request Decision Package, September 13, 2021.



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 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

**DEFERRED COMPENSATION PROGRAM
OVERVIEW**

Seth Miller
Retirement Readiness Director


Select Committee on Pension Policy
July 20, 2021



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Outline

- DCP overview
- Auto enrollment overview
- Roth 457 considerations



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DCP overview

- ❑ DCP is an optional, additional retirement savings vehicle
- ❑ It is an IRC section 457 plan
- ❑ All state agencies participate
- ❑ Local government employers can also participate or offer their own plan



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DCP investments

- ❑ Investments are selected by the WSIB
- ❑ 13 Retirement Strategy Target Date Funds
- ❑ 7 Individual “mutual fund” type investments



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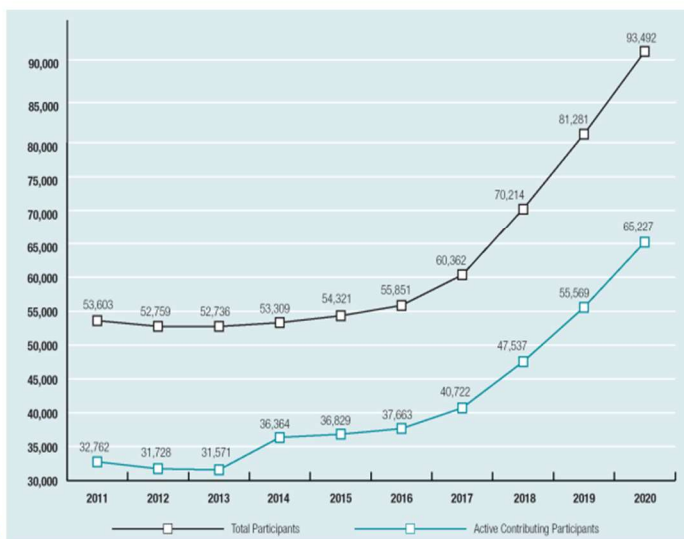
Administration of DCP

- ▣ Administrative options are determined by DRS
- ▣ Include options such as
 - Choice of Record Keeper
 - Fee structure
 - Loans
 - SECURE Act provisions
 - After-tax contributions (Roth)



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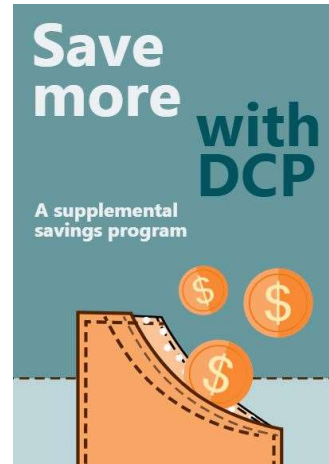
Growth in DCP participation



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DCP automatic enrollment

- Since January 1, 2017, all newly hired state and higher education employees are automatically enrolled in the state's Deferred Compensation Program



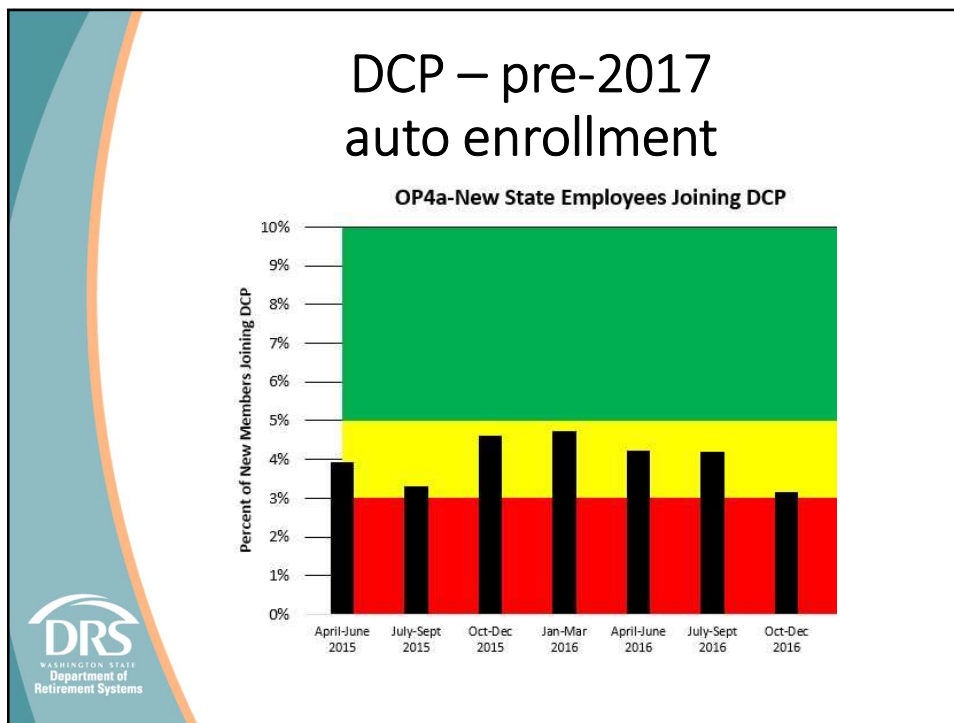
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DCP and automatic enrollment basics

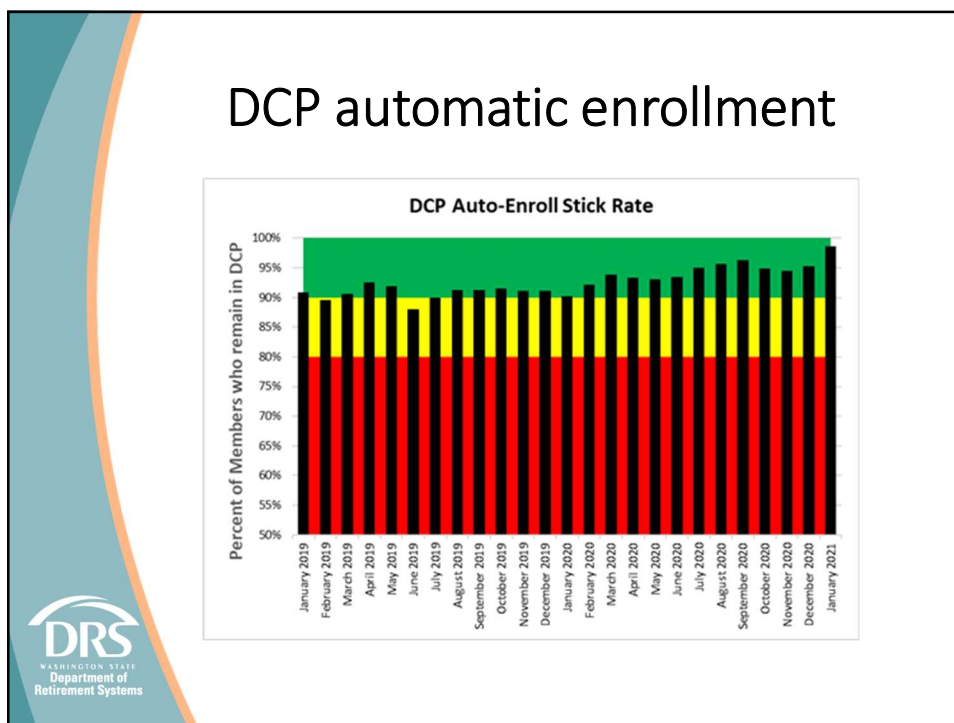
- Default contribution rate of 3%
- Default age appropriate Target Date Fund
- Contributions are refunded if member opts out within 90 days



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DCP automatic enrollment

- ❑ “Stick rate” is 87– 90%
- ❑ Average age of DCP participants has dropped from 47 to 42 since auto enrollment



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Automatic enrollment myths

Lower income workers will be less likely to participate.

- ❑ “...stats get even more impressive when looking at participation rates among minorities and lower income workers. “
- ❑ DRS has seen similar results in our own data.

Reference: <https://www.pai.com/blog/benefits-of-automatic-enrollment-in-a-retirement-plan>



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Roth 457

- ❑ Since 2011 457 plans have been able to offer a “Roth” option
- ❑ Contributions are made after-tax
- ❑ Contributions and investment returns are not taxed at time of withdrawal



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Roth IRA vs Roth 457

- ❑ Roth IRA
 - A private option - doesn't matter who your employer is
 - Workers who earn under a certain amount can contribute
 - \$6000 yearly limit if under age 50
- ❑ 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
 - \$19,500 contribution limit for those under age 50



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Why DRS currently does not offer a Roth 457 option

- ❑ Previous related implementations of higher priority
 - Auto enrollment
 - New Employer Reporting Application
 - Record Keeper transitions
- ❑ Generally low take up rates for Roth options
 - 12% of employees in 401(k) plans
 - Limited but vocal interest from participants
- ❑ Added complexity for both employers and customers



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Other considerations

- ❑ Cost/Effort of implementation
 - Internally developed DRS fiscal note estimates an implementation cost of approximately \$640,000
 - Without legislative funding, cost would be paid by DCP participants
 - Cost to employer community is unknown
- ❑ Possible federal legislation
 - Secure Act 2.0



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Questions?



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Agency Recommendation Summary

The Department of Retirement Systems (DRS) requests funding to add a Roth option to the state’s Deferred Compensation (457) Program. The agency has received requests from members to implement such an option within the state’s 457 Plan. Some individuals prefer to invest for retirement with contributions that have already been taxed, and a Roth 457 has higher contribution limits than a Roth IRA.

Fiscal Summary

| Fiscal Summary <i>Dollars in Thousands</i> | Fiscal Years | | Biennial | Fiscal Years | | Biennial |
|---|--------------|-------|----------|--------------|------|----------|
| | 2022 | 2023 | 2021-23 | 2024 | 2025 | 2023-25 |
| Staffing | | | | | | |
| FTEs | 0.0 | 3.0 | 1.5 | 2.5 | 0.0 | 1.25 |
| Operating Expenditures | | | | | | |
| Fund 001 - 1 | \$0 | \$609 | \$609 | \$379 | \$0 | \$379 |
| Total Expenditures | \$0 | \$609 | \$609 | \$379 | \$0 | \$379 |

Decision Package Description

What is the problem, opportunity or priority you are addressing with the request?

Members would like the opportunity to save for retirement using a Roth option, which essentially means that their contributions would be taxed as they’re going into the fund, as opposed to when they’re coming out of the fund. Although members can already contribute to a Roth IRA, separate from the state’s system, contribution limits would be higher in a Roth 457.

What is your proposal?

DRS requests that funding be provided to enable DRS to implement a Roth option in the state’s Deferred Compensation Program (a 457 Plan).

What are you purchasing and how does it solve the problem?

The decision package would provide funding to build a Roth option into the state’s DCP over a period of 18 months. The funding package buys:

- FTEs, as outlined in the table under Workforce Assumptions, to implement the Roth program.
- Contracted record keeper services.
- Contracted programmers to augment existing DRS systems.
- Contracted management consulting with retirement expertise to support the agency in implementing the solution.

What alternatives did you explore and why was this option chosen?

The alternatives looked at different ways to fund an implementation project. The three alternatives explored were: 1) seek state funding to put the Roth in place, 2) increase the fee paid by all participants for administration of DCP or 3) establish a unique admin fee to be paid by only those members who choose to participate in the Roth.

The first option is recommended because of the impact of a fee increase relative to the low participation rates seen in other retirement systems who offer Roth options. The second option would represent a significant increase in the administrative fee paid by all participants during implementation while studies have identified that participation would only be around 10 percent. The fee required by the third option would be very difficult to calculate because it would depend not only on the number of active members who decide to start contributing to a Roth but also how many active and terminated members decide to convert existing assets to a Roth. Without a large asset base quickly shifting to the Roth option, recovering implementation costs would either require a significant short term fee increase or assessment of the fee over a period of years.

Assumptions and Calculations

Expansion, Reduction, Elimination or Alteration of a current program or service:

Adding a Roth option to the state’s DCP would expand the existing program by giving DCP members a post-tax option to defer compensation into additional retirement savings.

It is important to keep in mind that adding a Roth option is not the same as adding a new investment choice, as how retirement funds are taxed is different than how retirement funds are invested.

Budget authority for DCP in the 2021-23 Biennium is \$2,300,000 in FY 1 and \$2,301,000 in FY 2. The estimated cost of the 18-month project would represent a 29% increase in the cost of the program over the duration of the project.

Detailed Assumptions and Calculations:

Administrative Assumptions

To develop this decision package, DRS made the following administrative assumptions for the implementation of the Roth option:

- DRS will need to create a new/separate plan in multiple DRS automated systems for managing Roth reporting and dollars.
- Roth will need to be set up with our existing record keeper for DCP, which will require them to make system changes, develop business requirements and conduct testing with DRS.
- WACs for DCP will need to be updated.
- DRS will need to update business procedures for internal operations (e.g., Trust Accounting, Accounts Receivable, and Retirement Services) to address new requirements.
- Roth contributions will be combined with existing pre-tax contributions for the calculation of the existing annual maximum for 457 plans.
- DRS will limit automatic enrollment default contributions to pre-tax dollars only, with an in-plan rollover option available to customers afterwards.
- Employers will be able to use the same Report Group to report Roth contributions as they use to report pre-tax contributions in DCP.
- Employer training materials will need to be updated to include Roth instructions and employer training webinars will need to be developed and training facilitated.
- DCP plan materials for members will need to be updated to include Roth information.
- Letters will need to be mailed to existing DCP customers by the Record Keeper, notifying them of the new Roth option.
- DRS anticipates an increased workload for approximately one year to support new enrollments and rollovers.

Note: Public employers who participate in the state's DCP may need to make changes to their own payroll system(s). DRS is not able to estimate that cost so it is not included in this decision package.

Calculation Assumptions

The salaries and benefits for all proposed FTEs are provided in the workload assumptions below, while management consultation and contracted programmers are both based on contracts we currently have in place for comparable services.

Workforce Assumptions:

| Job Classification | Annual Amts | | FY 2022 | FY 2023 | FTEs: | | |
|----------------------------------|-------------|----------|------------|------------|------------|------------|------------|
| | Salary | Benefits | | | 2021-23 | 2023-25 | 2025-27 |
| Retirement Specialist 3 | \$61,224 | \$24,246 | | 0.15 | 0.1 | 0.04 | 0.0 |
| Mgmt Analyst 5 | \$88,644 | \$29,241 | | 0.20 | 0.1 | 0.05 | 0.0 |
| IT Busn Analyst-Jrny | \$96,888 | \$30,744 | | 1.00 | 0.5 | 0.25 | 0.0 |
| IT Proj Mgr - Mgr | \$123,636 | \$35,617 | | 1.00 | 0.5 | 0.25 | 0.0 |
| Comm Consult 5 | \$84,396 | \$28,469 | | 0.13 | 0.1 | 0.03 | 0.0 |
| IT Applications Developer-Senior | \$112,167 | \$33,731 | | 0.29 | 0.1 | 0.06 | 0.0 |
| Rules Coordinator | \$86,944 | \$29,090 | | 0.05 | 0.0 | 0.00 | 0.0 |
| Fiscal Analyst 2 | \$54,108 | \$22,949 | | 0.05 | 0.0 | 0.01 | 0.0 |
| Fiscal Analyst 5 | \$78,408 | \$27,377 | | 0.15 | 0.1 | 0.04 | 0.0 |
| Office Assistant | \$42,428 | \$20,899 | | - | - | 0.50 | 0.0 |
| Total FTE's | | | 0.0 | 3.0 | 1.5 | 1.2 | 0.0 |

How is your proposal impacting equity in the state?

The proposed option would be available to all public employees who work for employers that participate in the state’s DCP. Additionally, funding the project out of the State General Fund would eliminate the cost to members who may never choose to participate in the Roth option. Studies have identified that although numerous 457 plans currently offer Roth options, only around 10 percent of members participate.

Strategic and Performance Outcomes

Strategic Framework:

This package supports DRS’ strategic plan as it represents the addition of a retirement savings option requested by members.

| Performance Measures | Incremental Changes 2022 | Incremental Changes 2023 | Incremental Changes 2024 | Incremental Changes 2025 |
|---|--------------------------|--------------------------|--------------------------|--------------------------|
| 000622 - Number of new deferred compensation participants | 0 | 0 | 0 | 0 |

Performance Outcomes:

Implementation of a Roth option may increase the number of new participants in the state’s DCP although it is anticipated that a number of the eventual members in the Roth will be existing participants who change from pre-tax to post-tax contributions.

Other Collateral Connections

Puget Sound Recovery:

N/A

State Workforce Impacts:

N/A

Intergovernmental:

N/A

Legal or Administrative Mandates:

N/A

Stakeholder Response:

Implementation of a Roth option would respond to member requests from a small population as well as comments from local government employers.

Changes from Current Law:

N/A

State Facilities Impacts:

N/A

IT Addendum

Does this Decision Package include funding for any IT-related costs, including hardware, software, (including cloud-based services), contracts or IT staff?

No

Objects of Expenditure

| Objects of Expenditure <i>Dollars in Thousands</i> | Fiscal Years | | Biennial | Fiscal Years | | Biennial |
|---|--------------|-------|--------------|--------------|------|--------------|
| | 2022 | 2023 | 2021-23 | 2024 | 2025 | 2023-25 |
| Obj. A | \$0 | \$309 | \$309 | \$191 | \$0 | \$191 |
| Obj. B | \$0 | \$91 | \$91 | \$67 | \$0 | \$67 |
| Obj. C | \$0 | \$209 | \$209 | \$121 | \$0 | \$121 |
| Obj. E | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 |

Agency Contact Information

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mark.feldhausen@drs.wa.gov



Roth 457/Deferred Compensation Option

Comprehensive Report
November 17, 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

Why is a Roth option not currently available?

- DRS is the plan administrator for DCP, and 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
- Since 2014, DRS presented to the LEOFF 2 Board multiple times their intent to implement a Roth option for DCP
- In 2021 DRS informed the Board they were no longer prioritizing resources to implement a Roth 457 Plan option at this time

Update since June Board Meeting

- In July, the SCPP received a briefing from DRS that identified more detail regarding why they were not planning on implementing a Roth 457 option:
 - Previous related implementations of higher priority
 - Generally low take up rates for Roth options
 - Added complexity for both employers and customers
 - Cost/Effort of implementation
 - Possible federal legislation

DRS Budget Proposal

- In September, DRS filed a Budget Proposal with the Governor's Office to implement a Roth 457 option
 - Budget request is for General Fund money, meaning no admin fee increase to members
 - \$609k in 2021-23 and \$379k in 2023-2025
 - Governor's Budget scheduled to be released December 21

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
- DRS estimates approximately 12% (423 LEOFF 2 members) of LEOFF 2 members enrolled in DCP will use the Roth option

Policy Options

- **Option 1: No action at this time**
- **Option 2: Endorse legislation**

Next Steps

- No action necessary at today's meeting
- Final briefing at the December 15th Board meeting



Thank You

Jacob White

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