

MEMO

TO: Connecticut Retirement Security Board
DATE: October 30, 2015
FROM: Mercer
SUBJECT: Traditional vs. Roth IRA

Introduction

The legislation anticipates that the Retirement Security Program (the Program) will be established using individual retirement accounts (IRAs); however, the statutes have not specified what kind of IRA nor have they required the Connecticut Retirement Security Board (CRSB) to specify a type. Because the Program is envisaged as an auto-enroll with opt-out approach, there are likely to be many passive participants, i.e., people who do not make an active decision to participate, so the Legislature will need to specify a default IRA account type or require the Governing Body to specify a default during the implementation phase. To the extent the CRSB wants to make a recommendation around what the default should be, this memorandum provides a basis for forming an opinion and outlining a recommendation.

IRAs can be either pre-tax (conventional or traditional) or post-tax (Roth). The tax deductibility, withdrawal allowances and restrictions, and penalties will have an impact on participants and their actions. This memorandum starts with a general comparison of traditional and Roth IRAs, outlining the critical differences and considerations for the CRSB in deciding whether and what recommendation to make to the Legislature. We then consider results from the market survey and broader research. We conclude with some thoughts on potential recommendations.

Comparing Traditional and Roth IRAs

EXHIBIT 1: TRADITIONAL VS. ROTH IRA

	Traditional	Roth
Income limits	None	Single: \$116k – 131k ¹ Married, filing joint: \$183k – 193k Married, filing separate: \$0 - \$10,000
Contribution limits	\$5,500 (<50 years old)	\$5,500 (<50 years old)

¹ The bottom of the range reflects the income point at which the contributor must begin to phase out contributions.

	Traditional	Roth
	<p>\$6,500 (50 + years old)</p> <p>\$0 (70 ½ + years old)</p>	<p>\$6,500 (50 + years old)</p>
Tax deductibility	<p>Contributions for federal and state taxes fully deductible for single filers with a modified AGI of \$61k or less or married filers with a modified AGI of \$98k or less. The deduction is phased out for higher income earners. The deduction may also be limited if the participant's spouse participates in an employer-provided plan.</p> <p>Withdrawals taxed as ordinary income.</p>	<p>Contributions are made with post-tax income, so contributions are not deductible. Earnings and withdrawals are generally tax free after 59 ½ and 5 years after first contribution.</p>
Withdrawal restrictions	<p>Typically a 10% penalty plus taxes for withdrawals before 59 ½.²</p>	<p>No restrictions or penalties on withdrawing contributions before 59 ½, but earnings attract taxes and are subject to a 10% penalty (unless an exception is available).</p>
Withdrawal requirements	<p>Required minimum distributions (RMD) at age 70 ½.</p>	<p>No requirements until after death of the participant.</p>
Ability to consolidate assets into the Program	<p>Participants can roll traditional 401(k) and other pre-tax balances into the account.</p>	<p>Participants can roll Roth 401(k) or Roth IRA assets into the account.</p>
Ability to move assets to other retirement plans	<p>Participants can roll to another traditional IRA or an employer provider retirement plan (e.g., 401(k) plan).</p>	<p>Participants can roll to another Roth IRA. Assets cannot be rolled into an employer provider retirement plan.</p>

Market survey and research

The Center for Retirement Research (CRR) tested whether the tax status of the IRA would have an impact on employee opt-out rates. The conclusion showed no significant differences in opt-out rates between the two options. Other research and historical surveys looking at the 401(k) market suggest that tax deductibility of contributions is important to participants at all wage levels, but particularly for

² Exceptions do exist. For example, withdrawals due to disability, death, long-term unemployment expenses, certain major medical expenses, first-time home purchase or to pay for an education can be exempt from the penalty.

lower income participants. An EBRI brief (Van Derhei, 2011) used the 2011 Retirement Confidence Survey (RCS) to assess whether individuals at different income levels were incentivized by the tax deductibility of 401(k) contributions. The presumption was that higher-income employees would be the most influenced by the tax deductibility of contributions. As presented in Van Derhei's report "To better understand potential participant behavior, the ... [RCS] asked respondents the importance of being able to deduct their retirement savings plan contributions from their taxable income in encouraging them to save for retirement. When confined to full-time workers (n=591), the weighted results were as follows:

Not at all important	4.3%
Not too important	5.0%
Somewhat important	27.8%
Very important	61.5%

In-depth data analysis showed that people in the lowest household income category (\$15,000 - \$25,000) had the largest percentage of respondents classifying the tax deductibility of contributions as very important (76.2%).

The RCS then asked people currently saving for retirement what actions they would take if they could no longer deduct the contributions from taxable income. When confined to full-time workers (n=460), and eliminating those who refused to answer or responded that they did not know, approximately 26% indicated that they would reduce their contributions if the ability to deduct contributions from taxes was eliminated. The lowest-income category had the largest negative reaction with 56.7 % indicating that they would reduce savings. This data relates to people's choices when existing tax benefits might be taken away, so one cannot draw specific parallels or conclusions with regard to how lower income workers might view tax benefits associated with an IRA; however, the income tax benefit may be an important consideration and potentially is an incentive even at lower income levels.

Illustrating the income tax effects

To put the tax benefit in context, consider an example of a person earning \$43,000 annually. For comparison, assume contribution rates to an IRA of 3% and 6%. Exhibit 2 below shows the tax calculations.

EXHIBIT 2: TAX DEDUCTION IMPACT ON NET INCOME

Traditional IRA			Roth IRA		
Salary	\$43,000	\$43,000	Salary	\$43,000	\$43,000
Contributions	3%	6%	Effective Tax Rate	21.0%	21.0%

Contributions	\$1,290	\$2,580	Tax Owed	\$9,030	\$9,030		
Taxable Salary	\$41,710	\$40,420	Net of Taxes Salary	\$33,970	\$33,970		
Effective Tax Rate	21.0%	21.0%	Contributions	3%	6%	Differential in Take-home Pay	
Tax Owed	\$8,759	\$8,488	Contributions	\$1,290	\$2,580	3%	6%
Take-home Pay	\$32,950	\$31,931	Take-home Pay	\$32,680	\$31,390	\$270 (0.63 %)	\$541 (1.26%)

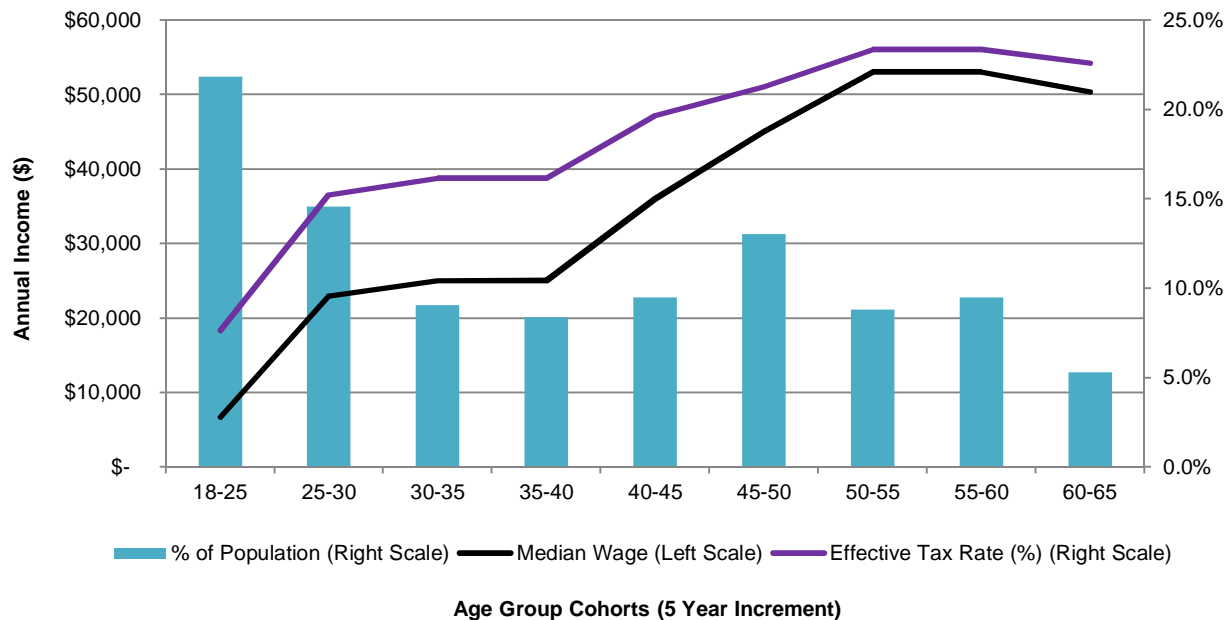
* Tax rate calculation assumes single, 1 personal exemption, 0 dependents, and 1 standard deduction.

With a conventional IRA, take-home pay is \$270 per annum greater than with a Roth IRA at a 3% contribution rate. In terms of percentages, this amount equals to approximately 63 basis points. At a 6% contribution rate, the differential increases to \$541 per annum or 126 basis points. In a program where fee sensitivities are expected to be a significant factor, this incremental difference can have a real impact on the participants' overall savings experience. Notably, the wealth accumulation is the same under the pre- and post-tax models, so in a conventional IRA the participant is better off in terms of take-home pay and indifferent to the wealth accumulation in terms of the overall balance. We note, however, that there are differences in the participants' ability to access the accumulated wealth, which may be positive or negative depending on the policy goal(s). These points are discussed in greater detail below.

Tax rate changes over time

In practice, individuals accumulate pre- and post-tax savings at different tax rates over time. In assessing whether the default should be a traditional or Roth IRA, the target population's age and tax rates should be considered. A younger person in a lower tax bracket is more likely to benefit from a Roth IRA than a middle aged person in the same tax bracket, as the younger person is more likely to have a higher tax bracket at retirement and can draw down the Roth savings generally tax free. A middle aged person in the same lower income tax bracket is less likely to retire in a higher tax bracket and is more likely to benefit from the tax deductions in the immediate term.

EXHIBIT 3: MEDIAN WAGE AND TAX RATES ACROSS AGE COHORTS FOR THE CONNECTICUT UNCOVERED POPULATION



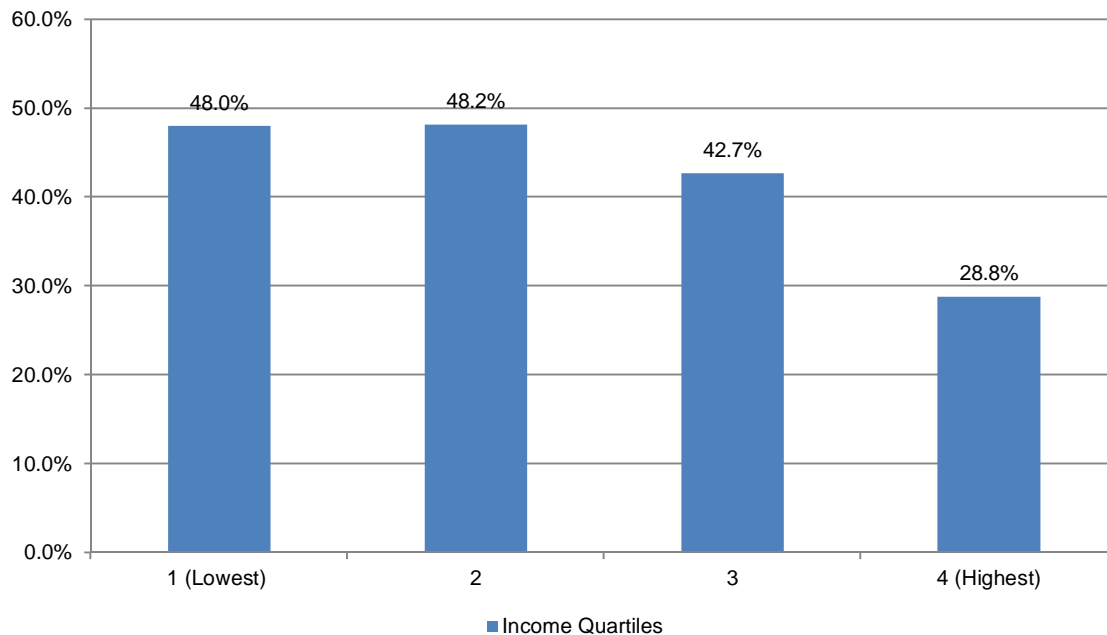
Source: US Census Connecticut data and Mercer calculation of uncovered population
Tax rate calculation assumes single, 1 personal exemption, 0 dependents, and 1 standard deduction

Access to accumulated savings

As noted in the annuities and retirement income strategy discussions, the Legislature has articulated policy goals with multiple dimensions: encourage accumulation of savings to promote retirement income while not putting individuals into poverty. Consequently, the CRSB's recommendation on a default option must balance targeting asset accumulation and an income replacement ratio for retirement with creating a situation where an individual cannot access capital and potentially incurs high cost debt or experiences significant financial stress as a result. The penalties associated with traditional IRAs may result in a more negative outcome versus not saving in the Program for a portion of the population. In contrast, easy access to accumulated savings in the Program could allow leakage. The CRSB should consider how to balance these items in taking an overall decision.

A National Bureau of Economic Research study (Poterba, Venti, & Wise, 2011; revised 2013) analyzed the likelihood of withdrawals from personal deferral retirement accounts (PDRAs) based on asset level and health. They found that all else constant, individuals with limited savings outside their PDRA and in poor health are more likely to draw on the PDRA savings. This finding is consistent with EBRI analysis (Banerjee, May 2013) showing retired households between ages 61 and 70, i.e. not required to make a withdrawal, with lower income are significantly more likely to draw on their IRA savings, as shown in the chart below.

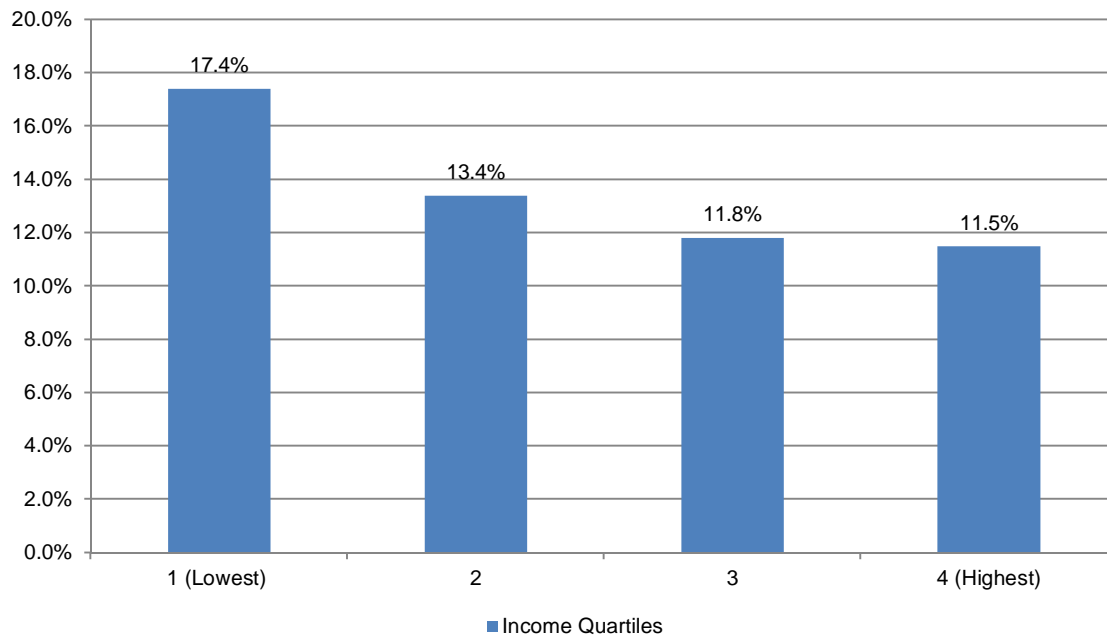
EXHIBIT 4: PERCENTAGE OF RETIRED HOUSEHOLDS BETWEEN AGES 61 AND 70 MAKING IRA WITHDRAWALS, BY INCOME QUARTILE



Source: Employee Benefit Research Institute estimates from Health and Retirement Study (HRS), 2002 to 2010

The withdrawal amount relative to the total account balance is also important. According to the EBRI analysis (Banerjee, May 2013) younger households drawing down their IRAs tended draw out more money and spend most of it. The difference between people across income levels is shown in exhibit 5 below. The data shows what is intuitively expected: households earning at lower income levels are likely to need earlier and greater access to their savings.

EXHIBIT 5: PERCENTAGE OF IRA BALANCE WITHDRAWN ANNUALLY BY RETIRED HOUSEHOLDS BETWEEN AGE 61 AND 70, BY INCOME QUARTILE



Source: Employee Benefit Research Institute estimates from Health and Retirement Study (HRS), 2002 to 2010

Compliance and operational issues

As noted above, the IRS restricts Roth IRA contributions to people below specific income levels. While less than 10% of the uncovered population earns more than this income level, the Legislature and Program operations must consider how to handle these individuals. Similarly, if an individual over contributes to a traditional IRA, the person may incur penalties. We understand from legal counsel that, generally, individual IRA owners are solely responsible for ensuring compliance with IRS contribution and deduction rules, and they would be responsible for any associated penalties. Legal counsel has noted that, from an operational standpoint, it would be difficult for the Program to determine whether a potential participant exceeds the contribution limits. Consequently, they have recommended that the Program provide upfront disclosures to warn potential participants about income and deductibility limitations. Additionally, the CRSB and the Legislature should consider how an individual's compliance issues might reflect on the State's overall reputation.

CRSB recommendation options

The CRSB can simply support the Legislature's decision to implement the Program using IRAs. Alternatively, the CRSB can recommend one or both IRA types be offered, but not suggest a default

option leaving the decision for the implementation phase. Finally, the CRSB can recommend one or both IRA types be offered and identify a particular IRA type as the default option.

Works Cited

- Banerjee, S. (May 2013). *IRA Withdrawals: How Much, When, and Other Saving*. Washington D.C.: Employee Benefit Research Institute.
- Poterba, J. M., Venti, S., & Wise, D. A. (2011; revised 2013). *The Drawdown of Personal Retirement Assets: Husbanding or Squandering?* Cambridge, MA: National Bureau of Economic Research.
- Van Derhei, J. (2011). *"Tax Reform Options: Promoting Retirement Security"*. Washington DC: Employee Benefit Research Institute .

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