

Roth 401(k)s Are the People's Choice

By Kerry Pechter Thu, Aug 17, 2017

New research suggests that the majority of participants, without doing the math, might actually prefer to get taxes on their savings out of the way today and have the pleasure of looking forward to tax-free income in retirement.



Encouraging or requiring the conversion of 401(k) plans—or 401(k) contributions above a certain level—into Roth 401(k) plans is one of the deficit-reducing changes said to be under consideration by staffers at the Senate Finance committee as they try to reform the tax code.

Here's the logic: A switch to Roths could boost federal tax revenues by capping or eliminating the deferral of income taxes on 401(k) contributions until age 70½. Instead, contributions would be taxed and withdrawals wouldn't be.

Now comes research showing that "taxpayers generally prefer back-loaded plans [Roth 401(k)s] over front-loaded plans [traditional 401(k)s]." This finding was published in a recent [paper](#) from the Center for Retirement Research at Boston College.

Oddly enough, many people seemed to prefer Roth 401(k)s without necessarily understanding the tax implications of doing so. In fact, most were unaware of the tax implications and many preferred Roths even if the switch produced worse financial outcomes.

"Our results suggest that individuals, on average, do not respond 'rationally' to the relative economic incentives associated with alternatively structured plans," wrote Andrew D. Cuccia of the University of Oklahoma and Marcus M. Doxey and Shane R. Stinson of the University of Alabama.

But individuals didn't necessarily act *irrationally*. The preference for Roth 401(k)s may simply confirm certain principles of behavioral economics. The authors mentioned four of those principles in their paper and suggested their impact on the preference for Roth 401(k)s:

Prospective mental accounting. It's possible that people can in fact delay gratification.

"Thinking about the pleasure of consumption can blunt the pain of paying for it," the paper said.

"Taxpayers may anticipate greater overall net utility from the income if the related tax is paid prior to its receipt, as in a back-loaded plan... With a front-loaded plan, taxpayers may consider the tax cost of the savings twice; once indirectly at the time of contribution when the savings are set aside and again upon receipt when the taxes are actually paid."

Framing and intertemporal reference points. Behavioral economists have shown that losses generally loom larger in the mind than gains. "If taxpayers adapt to paying taxes currently on income, investment in

a front-loaded savings vehicle might be framed as a deferral of that tax, or the trade of an immediate gain for a future loss," the paper said.

Dread. It's possible that participants are quite aware that they will pay tax on required minimum distributions from tax-favored accounts in the future, and they don't like it hanging over them. "If taxpayers focus on the taxes actually paid, they may prefer to "get it over with" and pay those taxes now, as required of a back-loaded plan, avoiding the dread associated with the looming payment required by a front-loaded plan," the paper said.

Uncertainty. Many people are now converting traditional IRAs to Roth IRAs out of fear of potential tax hikes in the future, participant may be applying the same logic when they prefer Roth 401(k)s to traditional 401(k)s. "A back-loaded plan may be seen as a relatively more "certain" prospect because the taxpayer knows both the tax rate on current contributions and, therefore, the amount of taxes being paid, as well as the tax (none) that will be due on subsequent earnings and qualifying withdrawals," the paper said. "Neither future tax rate changes nor the taxpayer's economic status will impact the amount of taxes paid and saved."

Switching to a Roth-based defined contribution system would probably make life a whole lot simpler for most people. Wealthy retirees hate the RMDs because it forces them to take taxable distributions they wouldn't otherwise take. (They tend to have amnesia about the benefits of tax deferral.) People tend to spend much of the benefits of tax deferral anyway, because the tax savings ends up in their paycheck, not in their 401(k) account.

The 401(k) industry (and the mutual fund industry, which regards defined contribution plans as an important distribution channel) will never allow an industry-wide shift to Roth-style accounts, however. They worry that participants will contribute less (or not at all) to their accounts without the attraction of tax deferral. And advisors who sell 401(k) plans to independent business owners worry that, if those owners can't shelter some \$50,000 a year from income taxes by sponsoring a plan, they won't sponsor a plan at all.