ROTH 401(K) PLANS FOR PRIVATE EQUITY POSITIONS

we don’t do ordinary. **we defend the egg.**

In Silicon Valley, and many other entrepreneurial hotbeds, venture capital and private equity firms regularly stake start-ups and small businesses on the brink of hitting the proverbial home run. The risks are huge but the reward is far greater.

Returns from these entrepreneurial endeavors can also provide an extremely attractive investment tool for retirement plans when used to fund a Roth 401(k). Most traditional Roth 401(k) plans limit available investments to a combination of mutual funds, exchange traded funds (ETFs), separate managed accounts or self-directed brokerage accounts. These investments generally earn a market rate of return over a long-term time horizon.

However, a qualified Roth 401(k) plan that holds private equity interests has the potential to generate exponential returns over a short period of time, and can be an attractive source of uncorrelated returns for investors.

For holders of private company stock in startup ventures, a Roth 401(k) creates a uniquely powerful opportunity to recognize exponential appreciation of their private equity positions and, then, to withdraw the appreciated positions completely tax-free at retirement age.

At Retirement Administration, Inc. (RAI), we are experts in Egg Defense and can properly design a Roth 401(k) plan for private equity positions.

HOW DOES A ROTH 401(K) WORK?

The Roth 401(k) works just like a Roth IRA in that taxes are paid up front when money is invested and the principal grows tax-free. Once the contributor reaches age 59 ½ and the Roth account has been open for five years, the money can be withdrawn tax-free.

However, the Roth 401(k) carries a few distinct advantages over its Roth IRA counterpart. First, unlike a Roth IRA, which prohibits individuals earning more than $120K per year—$176K per year if married, from contributing, the Roth 401(k) does not have any income limitations that restrict participation. If a company has a 401(k) plan with the Roth feature enabled, participants can contribute to the Roth 401(k) regardless of income.

In addition, the amount that can be contributed to the Roth 401(k) is substantially higher than in a Roth IRA. In a Roth IRA, a participant is limited to $5,500 per year in contributions, $6,500 if the contributor is age 50 or over. A Roth 401(k) allows a participant to contribute up to $18K per year, $24K if the contributor is age 50 or over. This effectively quadruples the amount that can be allocated to Roth retirement accounts.

Finally, a Roth 401(k) account has an important estate planning advantage over a regular 401(k) account when it comes to rollover opportunities. In a traditional IRA, the account holder must begin taking required minimum distributions (RMDs) at age 70 ½, regardless of whether or not the IRA holder needs the money. These RMDs increase dramatically with age, as they are designed to completely deplete the IRA at the account holder's actuarial death. Thus, the amount that can be passed on to future generations is substantially decreased, as the traditional IRA holder is required to withdraw the RMDs and pay income taxes on the distributions.

While all 401(k) accounts, both traditional and Roth, are subject to RMDs, Roth IRAs are not. Thus, high net worth individuals who do not need to access their retirement accounts for income, can roll their Roth 401(k) account into a Roth IRA, leaving their account intact for their heirs. Perhaps, most importantly, a Roth IRA that is bequeathed to an heir is subject to a distribution schedule based solely on the heir's life expectancy. Thus, if an heir inherited a Roth IRA account at 30 and lived to age 80, he or she would be entitled to withdraw the money from the Roth over the next 50 years. This preservation of compound growth is quite powerful when compared to the traditional IRA or 401(k) Plan option.

A ROTH 401(K) ACCOUNT HAS AN IMPORTANT ESTATE PLANNING ADVANTAGE OVER A REGULAR 401(K) ACCOUNT

WHICH IS BETTER: A ROTH 401(K) OR A TRADITIONAL 401(K)?

Estate planning considerations aside, the classic debate between Roth and traditional 401(k) contributions usually boils down to whether it is more advantageous to pay taxes up front and recognize both tax-free appreciation and tax-free withdrawals (the Roth route) or to make pre-tax contributions, grow a larger principal amount, but ultimately pay ordinary income taxes upon withdrawal (the traditional route).

The question is essentially one of timing and returns: at what point will the net withdrawals from the Roth 401(k) be greater than the net withdrawals from the traditional 401(k)? While the investor has paid taxes in the Roth structure at contribution in order to facilitate tax-free withdrawals, the investor must pay taxes on all principal and gains once withdrawals begin in the traditional structure.

The answer to this question is usually a close call and depends primarily upon:

- How long the contributions will remain invested
- The contributor's tax bracket both at the time of contribution and at the time of withdrawal
- The rate of return on the invested portfolio

It is this last factor, the rate of return on the invested portfolio, which creates the unique opportunity for private equity holders.

WHY IS A ROTH 401(K) POWERFUL FOR PRIVATE EQUITY POSITIONS?

For most of us, available investment options are limited to those that track to the market returns of their respective asset classes. Thus, equities are generally going to earn anywhere from three to12 percent and bonds are going to earn in the range of two to six percent, on average. Private equity, on the other hand, could return at much higher rates, which in a Roth structure means taxes are paid on the contribution when the cost basis of the stock is low and then the appreciated account balance is tax-free upon withdrawal.

In addition to the obvious tax benefits, the Roth 401(k) offers a unique opportunity for companies to attract and retain employees. A company that implements a Roth 401(k) provides employees the opportunity to invest in private company stock at a low cost basis with exponential appreciation potential. In an environment where companies are fighting for top talent, this kind of employment incentive can represent a significant bargaining tool for HR executives.

To illustrate the Roth 401(k) benefits, consider an investment in a startup company whose stock is valued at $.01 per share. Assume a participant in a company 401(k) plan makes a $10K deposit to the Roth 401(k) portion of their participant account. Because this Roth contribution is an after-tax contribution, the participant pays about $5K in income taxes as well (dependent on tax bracket – using 50% as the example), so the entire contribution has an out-of-pocket cost to the participant of $15K.

Now, assume they use the $10K investment to purchase a million shares of the startup company's stock inside a Roth 401(k). The company continues to experience success, and is eventually sold for $1.00 a share in cash to a publicly traded company. At this point, the original $10K investment inside the Roth 401(k) account would be worth a whopping $1 million, and the taxes would only be the $5K paid at the time of the contribution.

Now, if the participant waits until age 59 ½ and has, by that point, owned the Roth 401(k) for more than five years, the $1 million withdrawal (or any portion of it) is tax-free!

So how does a Roth 401(k) compare with a traditional 401(k)? If we assume everything else to be the same, the participant would end up with the same $1 million in the 401(k). However, the traditional 401(k) would not have the same tax treatment as a Roth 401(k), so income taxes must be paid on the withdrawals. At present, that would mean getting taxed at a rate of 40 to 50 percent (state & income dependent). So, up to half of the return, an enormous $500K, would go straight to the government in taxes. The participant would only net $500K. Not a bad return, but obviously not as good as keeping all of the money and only paying $5K when the contribution was made.

Consider a third option whereby the $10K investment is made through an individual (and taxable) brokerage account. The investment would be made on an after-tax basis, so taxes would be paid on the money when it was originally earned. Moreover, upon withdrawal, an investor pays capital gains taxes on the appreciation from the investment (most likely between 15 percent and 28 percent, or $150K and $280K) or ordinary income of 50 percent ($500K), depending upon the length of the investment holdings.

THE POWER OF ROTH 401(K)

A Roth 401(k) can provide huge tax savings compared to traditional accounts, where you may risk losing as much as 50 percent of your account balance to income taxes.

TYPE OF INVESTMENT	TRADITIONAL 401(K)	BROKERAGE	ROTH 401(K)
Initial Investment	$10,000	$10,000	$10,000
Roth Taxes Paid at Investment	$0	$0	$5,000
Value	$1,000,000	$1,000,000	$1,000,000
Taxes Paid at Withdrawals	$500,000	$280,000	$0
Amount Net of Taxes	$500,000	$720,000	$995,000

WHICH IS BETTER: A ROTH 401(K) OR A TRADITIONAL 401(K)?

ERISA rules that authorize trustees of a qualified retirement plan to invest in non-standard assets are complex, and plan sponsors may need special expertise to ensure proper plan design. First, the purchase of private company stock cannot be a "prohibited transaction," as defined under ERISA.

This essentially means that the stock cannot be purchased from a plan fiduciary or other entity providing services to the plan; instead, it must result from an "arm's length" transaction. Secondly, the stock must be independently valued within a year of the participant's purchase, to ensure the cost basis represented fair market value at the time of purchase.

ERISA provides broad discretion to the trustees of a retirement plan with regard to how plan assets are invested and specifically authorizes the investment of plan assets in non-standard assets in 401(k) plans. To include "alternative" assets like private company stock in a 401(k) plan, a company must be sure to comply with three primary requirements:

- It must ensure that the investment in private company stock does not represent a "prohibited transaction."
- The plan must ensure it does not discriminate against certain employees by offering all eligible participants the ability to invest in non-standard assets.
- Any private company investments must be accurately and fairly valued as of the date of purchase.

Once the three basic requirements are met, the plan sponsor must take appropriate steps to ensure the Roth 401(k) is properly drafted and administered. This is accomplished by engaging RAI as the plan's third party administrator (TPA), and RAI will find the custodian capable of holding private company stock as an asset.

The RAI financial advisory team is familiar with advanced corporate retirement plan designs. Throughout the plan year, the financial advisory team will coordinate and communicate with the platform provider and the third party administrator to ensure the private equity positions are appropriately accounted for and all requisite protocols are followed. On an ongoing basis, RAI will reconcile participant account balances and plan positions, ensure annual contribution limits have not been

RULES THAT AUTHORIZE TRUSTEES OF A QUALIFIED RETIREMENT PLAN TO INVEST IN NON-STANDARD ASSETS ARE COMPLEX exceeded, confirm all anti-discrimination tests are met, and file the proper annual IRS documentation reflecting the same.

This advanced plan design can easily be combined with more standardized 401(k) plans for employees who do not need or want to access alternative assets like private company stock, insurance or real property. In such a case, these employees would access the 401(k) investment options through a traditional platform and only those employees who wish to make private company investments would need to have visibility into the intricacies involved with holding such assets.

ROLLING A ROTH 401(K) TO A ROTH IRA

Since 2010, individuals have been able to convert all or a portion of their traditional IRAs to Roth IRAs, regardless of income. In addition, the IRS will now allow a Roth 401(k) to be rolled directly into a Roth IRA. This is significant for Roth 401(k) plan participants because it offers a convenient method by which the plan participants can exit the Roth 401(k) plan and roll the assets directly into a Roth IRA where they can be more flexibly managed without being constrained by the Roth 401(k) investment options available in the plan.

That said, there are some things to keep in mind when rolling over from a Roth 401(k) to a Roth IRA. First, it is critically important to understand that the five-year Roth clock starts ticking at the account level, not at the asset level. If a plan participant is contributing to a Roth 401(k) for five years, the Roth 401(k) account has met the five-year requirement. However, the Roth 401(k)'s satisfaction of the five-year requirement does not automatically extend to a Roth IRA account. The Roth IRA has its own clock and must be established and funded (with at least $1) for five years before the Roth 401(k) participant plans to take tax-free distributions from a Roth IRA into which the Roth 401(k) plan balance is rolled. Therefore, a plan participant who ultimately plans to roll their Roth 401(k) to a Roth IRA should convert a portion of their existing traditional IRA to a Roth and toll the five-year clock as soon as possible.

Once the Roth IRA account has met the five-year requirement, it is important to pay the taxes due as a result of the conversion from traditional IRA to Roth IRA with funds outside of the traditional IRA. Otherwise, the amount taken out to pay taxes will be considered an early distribution—if the participant is 59 ½ or younger—and will be subject to a 10 percent penalty. Once the conversion has been made, the ordinary income tax must be paid at the individual's then-current income tax levels.

However, conversion from traditional IRA to Roth IRA is not a zero sum game. One of the most interesting features of the Roth IRA conversion is the ability to convert it back to a traditional IRA, a process known as "reconstitution." Once per year, per account, an investor may choose to undo the Roth conversion and cause it to revert back to a traditional IRA account. It is as if the conversion from traditional to Roth IRA never happened. This is particularly useful when trying to manage for potentially dramatic fluctuations in the performance of the assets contained within the IRA.

Since the income taxes due as a result of the conversion are calculated based on the value of the account at the time of the conversion, the investor would owe significantly more in taxes than if they had made the conversion after the market decline. In this situation, the Roth IRA could be reconstituted back to a traditional IRA, and then converted back to a Roth IRA again to trigger a tax recalculation when the assets values are lower. Note that this can only be done once per year.

Another strategy involves the use of multiple Roth IRA accounts. Instead of converting a single traditional IRA account into a single Roth IRA account, it may be prudent to create multiple Roth IRA accounts and transfer different assets into each. This would allow the investor the flexibility to reconstitute those accounts that contained assets that dropped in value, while maintaining the Roth conversion in those accounts where the assets appreciated. This is particularly useful if an investor has access to truly non-correlated assets such as private equity, as those positions can be carved out on an account by account basis.

The Roth 401(k) and Roth IRA conversion opportunity is one that should be carefully explored by anyone who has access to private company stock as an investment option and is interested in utilizing a portion of that stock for retirement planning.

The ability to pay taxes while a stock's cost basis is low and then recognize tax-free accumulation and tax-free withdrawals is too powerful to ignore and should be given careful consideration. In many cases, enabling the Roth 401(k) feature in an existing 401(k) is as simple as checking a box on a form issued by the retirement plan provider. If a company is creating its 401(k) plan for the first time, the Roth 401(k) feature can be included right from the outset. Either way, there is no reason not to include the basic Roth feature as an option for plan participants.

Whether or not private equity positions will be included as part of the investment menu for Roth 401(k) contributions is a decision that should be explored with both a qualified financial advisory team, as well as a third party administrator with specific expertise in dealing with private equity positions in retirement plans. Moreover, the appropriate amount of private company stock an individual plan participant should allocate to the Roth 401(k) must also be carefully considered.

However, the additional time spent investigating and ultimately administering a Roth plan that includes private equity investments, is well worth the potential tax savings and retirement funding that could result from exponential private equity appreciation within the Roth account.

WHY WORK WITH RAI?

Retirement Administration, Inc. shields business owner salaries and company profits with hyper-funded retirement plans and maximum tax deductions. We can create customized plans with alternative assets into private equity investments to fortify and shield savings. Our advanced strategies work with Cash Balance Plans, tiered profit sharing, 401(k), ROTH and ROTH converted plans.

Business owners realize more in salaries and profits by making significant tax-deductible contributions, while still meeting non-discriminatory regulations with a qualified retirement plan design. The plans are flexible, tailored and unique. Owners get the recruitment and retention tool they need to be competitive while keeping costs to a minimum.

To learn more how RAI can help your business, protect your profits and reduce taxes, please call 1.800.608.2563 email dan@retirementadmin.com or visit us on the web.

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