

Understanding the New Roth 401(k)

There are plenty of ways to save for retirement. And come January 2006, many Americans will be faced with evaluating and deciding whether to use a new tax-sheltered way of investing for retirement -- the Roth 401(k).

Starting next year, employers sponsoring 401(k) and 403(b) plans will be able to offer "it" to participants as an added option, in accordance with the Economic Growth and Tax Relief Reconciliation Act of 2001, which President Bush signed into law on June 7 of that year and which was much better known for its major income tax reductions. While the Treasury Department has yet to release its final regulations, major elements of Roth 401(k)s are known, based on the 2001 act, on the Treasury's proposed regulations which were released for public comment last March 2, and on the retirement plan concepts long associated with the terms, "Roth" and "401(k)."

"Roth" IRAs were named in honor of the late Sen. William V. Roth, Jr., (R-DE), chairman of the Senate Finance Committee from September 1995 to January 2001, at whose initiative they were made available to individuals in 1998 as an alternative to traditional IRAs. Traditional IRAs generally permit individuals to (1) invest a sum of their *pre-tax* earned income, which means they may be able to deduct the contribution from their current taxable income, and (2) let the money grow tax-deferred, but (3) require them to pay taxes on withdrawals at then-prevailing tax rates (and with potential penalties for withdrawals before age 59 ½). Roth IRAs, on the other hand, enable individuals to (1) invest *after-tax* earned income (no tax deduction on contributions), (2) let it grow tax-deferred, and (3) take entirely tax- and penalty-free withdrawals (provided certain conditions are met). One additional major difference between a traditional IRA and a Roth IRA is that owners of a Roth IRA do not have to take required minimum distributions or RMDs. Those are the distributions that traditional IRA owners must take after reaching age 70 ½.

401(k) plans, long available to eligible employees of companies that offer them, more closely resemble the traditional IRAs. Participants may (1) have *pre-tax* income withheld to invest in employers' stock and/or a menu of mutual funds and other alternatives (employers may partially match contributions but the matched funds will be taxed as traditional 401(k) contributions), and (2) enjoy tax-deferred growth in their accounts, though they must pay taxes on the total amount of their pre-tax deferrals and any account growth at the time of distribution. 403(b)s, also known as Tax-Sheltered Annuities (or TSAs), are available to employees of schools and universities, churches, public hospitals, and charitable tax-exempt organizations. Some 403(b)s allow for employers to match contributions (similar to a 401(k) plan.)

Participants in these plans may be able to contribute (and deduct from taxable income) significantly more than the current \$4,000 (\$5,000 if age 50 or older) they are generally permitted when investing in IRAs. Thanks to the 2001 law, they may contribute and deduct \$15,000 in 2006 — up from this year's \$14,000 — plus an additional \$5,000 under a "catch-up provision" for individuals 50 or older.

Employers interested in sponsoring Roth 401(k) and 403(b) plans are presently (as of August 31, 2005) waiting for the Treasury to issue its final regulations – after completing its review of comments on its proposed set – so that they can know all they need to know to complete their plan designs and ensure that payroll and recordkeeping systems are ready for the additional work.

How many are likely to add Roth 401(k)s to their plans? No one knows, of course, but surveys of two overlapping groups of 450 and 200 large employers by Hewitt Associates, a major human resources services firm, have indicated that about 30 percent are somewhat or very likely to add such accounts to their plans in January. A Vanguard survey of its 401(k) plan clients indicates a similar level of interest.

Who should consider using a Roth 401(k)? Candidates include those who want to avoid required minimum distributions and those who predict that using the Roth will produce tax savings after factoring current and future income and current and future tax rates. In essence, participants – especially younger employees and low- to middle-income employees (those taxed at 10 or 15 percent) – who expect their tax rates to be higher during retirement (when they are likely to take a distribution from a retirement plan) could benefit from a Roth 401(k). Older employees who may be in the peak earning years and those who expect to be in a lower tax bracket during retirement might consider using the traditional 401(k), which allows them to defer taxes at high rates now and pay them at lower rates in the future. Of note, a person can contribute in aggregate no more than the \$15,000 (in 2006) maximum allowed, no matter which account is used - Roth 401(k) or traditional 401(k). But you can invest a portion of your deposits in both types of accounts, if both are available. Also of note, the Roth 401(k) has RMDs, but a rollover to a Roth IRA would avoid the RMD requirement.

According to the Vanguard Center for Retirement Research, participants who do get the chance to evaluate whether to use a Roth 401(k) may fall into other categories, including:

- **Maximum savers**, mostly earning high-income or having high net worth, who will be contributing at the limit of \$15,000 (or \$20,000 including the age 50 catch-up of \$5,000) and who may account for 10 percent of 401(k) participants. By keeping the maximum limits the same for pre-tax and Roth plans, Congress has effectively increased the savings that individuals can shelter from taxes in their retirement plans.
- **Participants who are well prepared for retirement** by saving more than the 6 percent median contribution rate, who are likely to be in the same tax bracket in retirement as today, and who face a risk of being in a higher bracket, in part because withdrawals from pre-tax plans would accelerate taxes due on Social Security benefits.

Those broad categories notwithstanding, 401(k) participants faced with the opportunity to use a Roth 401(k) should definitely consult a financial planner, asking them to prepare an analysis that incorporates likely tax rate and income scenarios. To be sure, the Roth 401(k) is likely to be an excellent retirement savings vehicle. But using it without proper analysis could lead to unintended consequences, namely this: choosing to make after-tax deposits now (i.e., paying taxes immediately) to get tax-free growth in the future may be a losing proposition if you're actually going to be in a lower tax bracket in the future - you will have voluntarily paid high tax rates to avoid low ones. In a nutshell, the choice boils down to paying taxes now (Roth IRA or 401(k)) or paying taxes later (Traditional IRA or 401(k)), with the variable being what the individual thinks their tax rates will be in the future compared to now.

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