

HOW TO BENEFIT FROM A ROTH 401K

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Starting next year, workers may have access to a new 401K savings option which is directed at decreasing their tax burden in retirement. Highly paid individuals are most likely to see the greatest benefit from the new Roth 401K.

The Roth 401K combines elements of the standard 401K, which is often invested in mutual funds, with the tax benefits of the Roth IRA. It allows individuals to contribute to tax deferred savings accounts with after tax dollars in exchange for the benefit of withdrawing that money tax-free in retirement. The standard 401k is funded with pretax dollars and withdrawals are taxed as income.

Roth 401(k) Facts

Contributions and Withdrawals:

- Employees will be able to designate funds in their 401k plans as ROTH contributions. Contributions and returns will then grow tax free until retirement.
- Roth 401k contributions will be subject to the same rules as traditional Roth IRAs: To be eligible for the tax free status, all contributions must be in the account for at least five years and cannot be withdrawn before retirement.
- Regular employees above age 50 can contribute \$15,000 to a Roth 401k plan.
- Participants age 50 or older are eligible for catch-up contributions of \$5,000 per year for a total of \$20,000 per year.
- These contribution limits apply to both types of 401k plans. Therefore, employees have to make a careful decision on how to split contributions between a Roth 401k and a regular 401k. The choice is mostly between different tax treatments.
- Roth plans do not require minimum withdrawals when the account holder reaches age 70½. Traditional 401(k) accounts require such minimum withdrawals.
- Tax-free status of a Roth 401(k) is subject to a 5 year term after the first contribution. Even if you prefer the traditional 401(k), it may be a good idea to make at least a minimal contribution to a Roth 401(k). In case you later decided to switch to a Roth 401k, the 5 year requirement will be much shorter.
- Roth 401(k)s are after-tax accounts and therefore allow employees to stack away MORE funds relative to using a regular 401k. Maxing out the \$15,000 contribution limit after tax equals roughly \$21,400 pretax assuming a 30% marginal tax rate. Thus, the Roth 401(k) effectively increases the amount of money that can be saved for retirement.

Opportunities:

- The greatest advantage of a Roth 401k is that money grows tax free with no taxation at the time of withdrawal.
- Roth 401(k)s allow employees to stack away MORE funds in real terms.
- Roth 401(k) accounts are a great option for employees who believe that income taxes will rise in the future. Taxes are paid at today's tax rate with the account being tax free in the future.
- Roth 401(k) accounts are beneficial for high-income employees who were previously unable to contribute to a Roth IRA. There are no income restrictions associated with Roth 401(k) accounts.
- What you see is what you get. Roth 401(k) contributions are after tax and grow tax free in the future. Your Roth 401(k) account balance is the actual amount you will have available at retirement.
- Employees who are unsure whether to contribute to a Roth 401(k) or to a traditional 401(k) may split contributions between both accounts. This allows for personal diversification of retirement funds in case tax rates will be higher in retirement.

Risks:

- The proposed Roth 401(k) rule is part of the Economic Growth and Taxation Relief Reconciliation Act. Under this law, the Roth 401(k) provision will sunset in 2010 unless extended by Congress. If Congress does not extend the Roth 401k provision, incremental contributions to a Roth 401k will not be possible.
- If taxes were to fall over the next 10-30 years, a Roth 401(k) plan participant's effective tax rate could be lower in retirement. In this case a Roth 401k account would be an inferior choice relative to a traditional 401k.
- Employers are not obligated to offer Roth 401k accounts. Some employers may decide against offering this new option to avoid the administrative burdens associated with offering two separate 401(k) plans.

Other Facts:

- Employer Matching Contributions are tax deductible for the employer and therefore have to be placed in a traditional 401(k) plan.
- According to a survey by employment benefits firm Hewitt Associates, 35% of companies are likely to have a Roth 401(k) option in place by 2006.
- Benefits experts are concerned that more 401(k) choices may actually confuse employees resulting in lower total 401(k) enrollments.
- "Roth" savings accounts, such as the Roth 401k and the Roth IRA, are named after Senator William V. Roth. Senator Roth was a Delaware Republican who introduced legislation to allow tax free individual retirement accounts.