

ROTH 401(k)

Employees, offered the option of a Roth account in the 401(k) plan encounter a difficult choice: Contribute to a Roth 401(k) and suffer a cut in take-home pay (since contributions are made with after-tax dollars), or remain with a traditional 401(k) and hope that in retirement, their individual tax rate will be lower than it is now. Alternatively, they could hedge their bets by contributing to both accounts.

Generally, making a fiscally wise decision depends on a reasonable estimation of the taxes you anticipate in retirement.

For those who expect their tax rate to be the same or higher in retirement than it is now, a Roth 401(k) may be the better choice. Most likely younger employees expect their income to increase in the future and if they are in the 15% or 25% tax bracket, it may be a good idea to pay the tax now, make their salary deferral into the Roth account and not have to anticipate what tax brackets might become in the future. However, for those employees who are midway or further through their career (peak earning years) and expect a lower tax bracket in retirement, continuing with traditional 401(k) contributions appears to be the wiser alternative.

Actually prediction with any certainty, of future circumstance including tax rates is nearly an impossible task. General consensus is that taxes and/or tax rates are not likely to decrease but are more likely to increase to pay for Social Security and Medicare. The decision is complicated by both personal and national budgetary concerns.

1. Who is eligible for a Roth 401(k)?

Anyone whose employer offers it. Employers may elect to offer the Roth option, it isn't required. Among the major concerns for employers are the costs associated with managing the plan, and educating their workforce about this new investment option. Companies are more likely to offer a Roth 401(k) if their employees indicate that they intend to participate.

2. What happens to the employer match?

Employer matches will still be made with pretax dollars, and the match will accumulate in a separate account that will be taxed as ordinary income at withdrawal.

3. What are the early withdrawal rules?

Early Roth 401(k) withdrawal rules will be subject to the same requirements as traditional 401(k)s.

4. What happens at the termination of employment?

The Roth 401(k) balance can be rolled over into a Roth IRA.

5. Is the Roth 401(k) option here to stay?

Yes, Pension Protection Act of 2006 made all of the EGTRRA provisions permanent.

Operation

If the employer offers the Roth 401k, participants have a choice to make: the entire deferral into the retirement in a traditional 401k account, all in a Roth 401k account, or split between the two. Here's how they compare.

Different Tax Treatment

Contributions to a traditional account 401k account reduce the individual's income for the year (less amount of income to report), which translates to a smaller tax bill in the year contributions were made – the individual pays the tax upon receipt of the deferrals and interest as a retirement benefit..

Contributions to a Roth account don't reduce the taxable income and therefore don't reduce the tax in the year of the contributions, but all the earnings in the Roth account are tax-free for as long as the account exists. Furthermore, at termination of employment you can roll your Roth 401k account to a Roth IRA, so the account can continue to grow with tax-free earnings for as long as you choose to preserve it.

No Difference in Contribution Limits

Roth 401k limits are the same as traditional 401k account limits. There is a single limit that applies to the overall total you contribute to both types of accounts. For example if the limit is \$15,000, it can be allocated to either type of account or split it between the two types, but the total contribution to both types can't be more than \$15,000.

No Difference in Investments

Generally the investment opportunities are the same for Roth 401k account as for traditional 401k account.

No Difference in Matching Contributions

If the employer provides matching contributions for retirement savings, the match will be the same for Roth 401k contributions as for traditional 401k contributions – the only difference is that the matching money must go into a traditional 401k account.

Example: The employer provides a 50% match on the first \$4,000 of 401k savings. If the employee contributes \$4,000 to a traditional account, the employer will add \$2,000, so a total of \$6,000 is deposited into the traditional account. Alternatively, If the employee chooses to contribute \$4,000 to a Roth 401k account instead, the employer will put \$2,000 into the traditional account. The total additions of \$6,000 to the retirement savings remains the same.

A simple way to choose the Roth account.

Why choose a Roth 401k account? The simplest reason is that the tax rules allow employees to accrue a Roth account just as large as a traditional account, but at retirement, the Roth account will be more valuable because it won't be taxed at distribution.

The Roth Account Is More Valuable

Nevertheless, it appears that the Roth account is more valuable at retirement. Distributions from a traditional account are taxable, but distributions from the Roth account are not. The difference can be surprisingly large. For example, if an individual is in the 25% tax bracket, he would have to withdraw \$133.33 from a traditional account to have \$100 in spending money, because \$33.33 will be used to pay tax on the distribution. The following chart shows the amount required in a traditional account to have the equivalent of \$100 in a Roth account, for each of the current tax brackets.

Amount Equivalent to \$100 in a Roth Account	
Tax Bracket	Amount
10%	\$111.11
15%	\$117.65
25%	\$133.33
28%	\$138.89
33%	\$149.25
35%	\$153.85

Saving in a Roth account can make you as much as 53% wealthier in retirement!

Paying Tax in Retirement

It is difficult to estimate what the tax bracket will be in retirement. If the estimate is that the tax will be on the low side, be sure not to overlook the following:

- More and more people work at least part time during "retirement," either to help make ends meet or simply to keep active.
- Up to 85% of your social security benefits can be taxable.
- With a sound investment approach, your retirement account should grow substantially over the years, and that will mean large withdrawals when you begin taking the money out. If the money is in a traditional account, these withdrawals will boost your income and possibly put you in a higher tax bracket than you might otherwise expect.

- There's reason to believe tax rates in general will be higher in the future as the federal government grapples with various budget realities, including huge costs associated with the aging and retirement of the baby boom generation.

So the Traditional Account Always Loses?

Not exactly. Choosing the Roth means paying more tax in the year of the contribution, because a Roth contribution doesn't reduce your taxable income. If the tax difference ends up as a difference in the total amount saved, it's possible for the traditional account to come out ahead.

Example: An individual is prepared to contribute \$1,000 per month to a traditional account, but switching to the Roth requires a cut-back to \$750 per month to allow for payment of tax due.

In this situation we can't be sure which account will end up providing more wealth in retirement. The Roth account starts out 25% smaller than the traditional account, and that means the traditional account can end up being more valuable if the tax rate in retirement is below 25%. Yet the Roth account has enough advantages so it can still end up winning.

To come out ahead with a traditional account, the individual must contribute more money than would have been contributed to a Roth account to allow for the taxation upon distribution in retirement.

For example, rolling the Roth 401k account to a Roth IRA will allow avoidance of the minimum distribution rules. Depending on your situation in retirement, this can be a huge advantage. The Roth IRA is a great estate planning tool.

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