

401(k) Plans soon to get Roth option

By Arvum D. Lank
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Officials at the R&B Wagner Co. are about to make a small decision with large consequences - whether to allow employees to put money into a new type of retirement plan.

Called a Roth 401(k), the plan allows workers to set up a company-sponsored retirement plan that will let them make completely tax-free withdrawals. The catch: They have to pay taxes on the money when it is put into the plan, even though Uncle Sam never gets a penny of the earnings.

That makes a Roth 401(k) the reverse of a regular 401(k), where money is tax free going in but taxable, earnings and all, coming out.

The 2001 tax reform act authorized Roths as an option in 401(k) plans as of Jan. 1, 2006. The law also allows a Roth option within 403(b) plans, which cover persons working for non-profit organizations.

As a result, companies such as R&B Wagner, which employs about 140 on Milwaukee's northwest side making ornamental iron work, are considering whether to add Roths. And companies that administer 401(k) plans, like Fiserv Inc. of Brookfield, are adjusting their systems to accommodate them.

At Wagner, the odds are good that a Roth option will be approved when a committee votes on the matter within the next 60 days, said Stanley J. Wos, chief financial officer of the private firm.

"I certainly will vote for it," said Wos, who is on the committee.

Whether he would avail himself of the option is another question.

At 57, Wos may be too old to benefit from paying taxes now to save taxes later. "I would have to run the numbers," he said.

That is the proper attitude, according to financial planners.

Making assumptions

The siren song of tax-free withdrawals tempts many, but that does not always make it the proper course. The reason: A dollar spent to pay taxes on money put into a Roth 401(k) may be more valuable invested than a tax-free dollar withdrawn from the account many years down the road.

To find out which is worth more, one must indeed "run the numbers."

To do so, assumptions must be made about tax rates today and when withdrawals will start, as well as investment returns.

None of those three variables can be known with certainty. As a rule of thumb, however, planners say that if a person expects to have a lower tax rate when withdrawals start than the tax rate they are paying now, then contributing to a Roth 401(k) probably makes sense.

Louis Kravitz & Associates Inc., a retirement plan consulting firm based in Encino, Calif., has posted a calculator at <http://lkravitz.com/roth/index.htm> that will compare returns from regular and Roth 401(k) at various tax rates and investment returns. It assumes that money saved in taxes upfront by using a traditional 401(k) is invested, not spent.

Brian L. Anderson, a CPA and attorney with the Madison firm of Dewitt Ross & Stevens who specializes in retirement plans, likes the Kravitz calculator, with one caveat - it assumes that once a person starts to contribute to a Roth 401(k), he or she will continue to do so every year.

Total contributions to a 401(k) of any type in 2006 can be a maximum of \$15,000 for those under 50, \$20,000 for those who are older. The money can be split between a Roth and regular account and all the contributions must be from earned income.

But rather than make a decision to put all the money into one account or the other forever, as the calculator assumes, a better approach would be to make the decision annually, when existing tax laws and investment returns can be better estimated, Anderson said.

Even so, the Roth option will eventually prove beneficial if enough time elapses, he said. That makes the option more attractive to younger workers.

That is especially true for people who would not have the discipline to invest the tax money saved by using a traditional 401(k).

Planning for uncertainty

Beyond hard numbers, there are other reasons to consider a Roth 401(k).

An important one is diversification of retirement investments, said Jeff Brodek, an attorney in Racine.

Tax laws and rates change over time. In fact, the Roth 401(k) option itself is set to expire in 2010,

although most people believe Congress will extend it.

Given that uncertainty, it is a good idea to have retirement funds in a number of different types of accounts. "You never know what will happen," Brodek said. "This gives you a different way to plan."

Other reasons to consider a Roth 401(k) include:

- Regular Roth IRAs are not available to high-income taxpayers, but there are no income limits for a Roth 401(k), noted Michael Francis, owner of Francis Investment Counsel LLC, Hartland. This can be a disadvantage, however, because people who are eligible for a Roth 401(k) but not a regular Roth are in high brackets, meaning they have to pay large taxes on the money put into such an account.
- Withdrawals from a Roth 401(k) will not count as income when considering how much of Social Security benefits will be taxed, at least under existing law.
- To be tax free, the person making the withdrawal must be at least 59 1/2 and have had the account for at least five years. Withdrawals must be made after age 70½, but that can be avoided by rolling the account into a regular Roth IRA, which has no such requirement.

The biggest obstacle may be getting an employer to offer the Roth 401(k) option. In making its decision, Wagner will consider the cost of doing so, Wos said.

Most companies that administer 401(k) accounts will offer the option at little or no cost, said John Newman, vice president for product management for Fiserv Investment Support Services, a subsidiary of the Brookfield firm based in Denver. "When we get new business, often they are coming from another provider," he said. "We will have to have this option for a plan to move to us."

Newman said he expects between 50% and 60% of Fiserv's clients to offer Roth 401(k)s by the end of next year.

That seems about right to Glenn Sulzer, an editor for CCH Inc., a tax information firm in Riverwoods, Ill.

"Basically, it is a competitive thing," he said. "An employer puts himself at a competitive disadvantage by not offering it."