

Roth 401(k) offers the best of both investment worlds

401(k) ADVISER

MICHAEL FRANCIS

Investing for retirement is about to get more interesting, as new Roth 401(k) rules go into effect at the beginning of next year.

These rules improve current 401(k) plans because they provide investors the opportunity to accumulate assets for retirement that can be withdrawn income tax-free.

For many, especially younger plan participants, the ability to withdraw accumulated investment earnings and pay no taxes is a significant enhancement to their 401(k) benefit.

If you like the Roth IRA, you'll love the Roth 401(k).

The tax treatment both accounts enjoy is similar. You make after-tax contributions into your account, and your contributions grow untouched by taxes and can be withdrawn in retirement with all accumulated earnings, income tax-free.

Additionally, the Roth 401(k) has some advantages over the Roth IRA.

First, the maximum annual contribution limit in 2006 will be more than three times higher for the Roth 401(k) - \$15,000 vs. \$4,000 for the Roth IRA.

If you're 50 or older, there is an additional \$5,000 "catch-up" contribution you can make to a Roth 401(k) account compared with only an additional \$1,000 to a Roth IRA.

Understand that the 401(k) contribution limit is a total limit that includes traditional pre-tax 401(k) contributions made in a given year, as well as any Roth after-tax contributions.

Another advantage is that there are no income restrictions limiting who can contribute to a Roth 401(k) account. This means that people with high incomes who have been unable to open a Roth IRA will now be eligible to contribute to a Roth 401(k) account.

Finally, unlike a Roth IRA, Roth 401(k) contributions will be eligible for matching contributions by your employer.

For years, financial planners have been telling clients to save for retirement in their employer's 401(k) plan up to the matching limit and invest the rest in a Roth IRA to take advantage of the favorable tax treatment.

Such gymnastics should no longer be necessary if employers amend their 401(k) plan and add the Roth feature.

Not for everyone

Before you rush out to complete your Roth 401(k) account paperwork, you should understand that Roth 401(k) contributions aren't for everyone.

To qualify for Roth's tax-free withdrawal provision, you must forfeit the upfront tax deduction for your contribution, which will reduce your take-home pay if you were previously saving in a traditional 401(k) account. Forgoing this deduction could even push you into a higher income tax bracket.

Furthermore, your contributions must remain in your Roth 401(k) account for at least five years, regardless of your age.

The loss of the upfront tax deduction will be offset over time by the tax savings you gain when you withdraw your investment earnings and pay no income taxes.

Whether the value of the tax break you receive by withdrawing your earnings income tax-free exceeds the value of the lost upfront tax deduction will be determined by three variables: the length of time you leave your savings in a Roth account, the rate of return you earn on your savings, and your tax bracket when you make contributions compared with your tax bracket when you take withdrawals.

According to numerous projections I have seen, figure on seven years as a break-even point if you're able to generate historically normal "market" returns on your savings and 10 years if you're conservatively invested.

Tax planning

The Roth 401(k) provides some meaningful tax planning advantages.

Most people would benefit from accumulating retirement assets in a Roth account to protect them from income taxes. Clearly, nobody knows where income tax brackets will be in 10 or 20 years, but if all of your retirement assets are subject to taxation as ordinary income when you need them, you are subjecting your standard of living in retirement to the risk of higher future tax brackets.

Roth 401(k) retirement assets could also come in handy when you begin receiving your Social Security benefits.

Many people are unaware that under current tax law, your Social Security benefits become taxable if you receive enough additional income from other sources, such as dividends, interest and distributions from traditional IRAs and 401(k) accounts.

Distributions from Roth 401(k) accounts and Roth IRAs will not count toward the limits of allowable other income, which could help shelter your Social Security benefits from taxation.

It is important to note that adding the Roth 401(k) feature to your plan is optional for your employer. Because there are still some technical issues the IRS has left unresolved regarding Roth 401(k) accounts, many employers appear hesitant to add this new feature and may miss the Jan. 1 initial availability date.

If your employer adds this feature to your plan, electing future contributions to go into Roth accounts will not be automatic. You will have to be proactive and elect to change your contributions from pretax to post-tax.

Now is the time to let your employer know you'd like to have access to a Roth 401(k) account. The more people who ask, the sooner you are likely to be granted access to this powerful new 401(k) feature.