



**401(k) ADVISER**  
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## For many savers, Roth 401(k) accounts are worth examining



Since being rolled out in January 2006 to the cheers of most of the financial planning community, Roth 401(k) accounts have yet to gain much traction with 401(k) savers.

According to a 2009 survey by Vanguard, only 7% of those with access to a Roth 401(k) account use one. I'm convinced that the primary reasons this powerful wealth accumulation tool has been largely ignored are a lack of information and apathy.

So let's review the basics of Roth 401(k) accounts.

Anyone, regardless of age or income, can make after-tax contributions to a Roth 401(k) account if one is made available by their employer.

Like a traditional 401(k) account, a Roth 401(k) account has a maximum annual payroll deduction contribution in 2010 of \$16,500. If you're 50 or older, there's an additional \$5,500 "catch-up" contribution allowed that brings the total up to \$22,000.

Roth 401(k) contributions also are treated like traditional 401(k) contributions in terms of their eligibility to be matched by your employer.

The big difference is that you receive no upfront tax deduction for your contribution to a Roth 401(k) and in exchange are allowed to withdraw all contributions and earnings free from taxation after five years of opening the account and age 59 ½.

Think about it: a lifetime of tax-free wealth accumulation instead of building a large retirement nest egg that will be subject to the prevailing income tax rate when you decide to withdraw your savings in retirement.

### Not for everyone

The key question you need to answer is whether the value of the tax break foregone is surpassed by the value of the tax break you will receive when you withdraw your earnings income tax-free.

This question is not easily answered because it requires you to predict the

future regarding the following three variables:

- The length of time you will leave your savings in the account.
- The rate of return you will earn.
- The difference between your tax bracket when you make contributions compared with your tax bracket when you take withdrawals.

After 3 1/2 years of meeting with 401(k) participants to discuss these difficult questions, my organization has identified a handful of 401(k) participant "profiles" to help guide your decision (see chart).

Theoretically, collecting your tax savings up front allows you to invest more and yields an identical amount of after-tax money at retirement than foregoing the deduction in exchange for tax-free distributions. This assumes your tax bracket does not change and you are able and willing to calculate the net cost difference between the two and invest the difference.

In my experience, the vast majority of retirement savers don't go to the trouble of investing their tax savings into a traditional 401(k) account, so many are likely to be better served funding a Roth 401(k) account.

While many financial planning experts agree with this point of view, not all do. That still doesn't explain the large number of employees who have yet to consider starting a Roth 401(k) account or employers who have yet to amend their 401(k) or 403(b) plans to allow their employees to make this decision for themselves.

If your employer has not made the Roth 401(k) account available, and you fit one of the profiles in the chart, do yourself a favor and ask your employer to add this feature to his plan.

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### Old school vs. new school

Savers have two kinds of 401(k) accounts to consider.

#### Comparison of the features of a traditional 401(k) vs. a Roth 401(k)

##### TRADITIONAL 401(k)

- Pre-tax contributions
- Earnings tax-deferred
- Savings taxed as ordinary income when withdrawn

##### ROTH 401(k)

- After-tax contributions
- Earnings tax-free\*
- Savings withdrawn with no taxes\*

\* If withdrawn after account open for five years and age 59 ½

#### Which 401(k) plan is right for you? These profiles may help you decide.

##### STICK WITH A TRADITIONAL 401(k) ACCOUNT

###### TEMPORARILY HIGH INCOME:

Commissioned sales people can experience dramatic swings in income. If you are having an unusually productive year, you may benefit more from the tax deduction in a high tax year provided by a traditional 401(k) contribution than the deferred benefit of tax-free earnings.

###### SHORT-TERM RETIREMENT SAVER:

In the short-term, the upfront tax deduction for your 401(k) contribution is almost always more valuable than tax-free treatment of earnings on your savings.

###### CURRENTLY QUALIFY FOR CERTAIN INCOME TAX CREDITS:

Shifting from pretax to after-tax saving could bump you into a higher tax bracket and put certain tax credits at risk.

###### UNSUCCESSFUL SAVER:

If saving for retirement has just not been a priority of yours, you may be better off with the upfront tax break than paying more taxes today in exchange for tax-free distributions on a limited amount of retirement savings.

###### CONVINCED U.S. TAX CODE WILL CHANGE:

If you believe that the U.S. tax code will shift away from its emphasis on the taxation of current income, a known tax break today may be worth more than the promise of a tax break of unknown value in the future.

##### CONSIDER A ROTH 401(k) ACCOUNT

**LOW TAX BRACKET TODAY:** Many American workers find themselves in a low (less than 15%) tax bracket and are well-advised to lock in this historically low tax rate by contributing after-tax dollars today in exchange for tax-free distributions in retirement.

###### YOUNG AGGRESSIVE INVESTOR:

Those with more than 30 years to go until retirement who plan on staying invested aggressively to maximize their long-term rate of return are likely to retire with significantly more investment earnings than contributions. Sheltering the earnings from taxation is a sound strategy.

**WEALTHY INVESTOR:** Someone with substantial savings already accumulated in tax-deferred accounts may desire to shelter future savings past age 70 ½, or pass wealth on to beneficiaries income tax-free.

**MAX CONTRIBUTOR:** If you can afford to contribute the maximum each year, Roth allows you to build a larger benefit in your 401(k) account for retirement because you are contributing after-tax dollars.

###### WORK FOR A COMPANY WITH GENEROUS COMPANY CONTRIBUTIONS:

All company contributions to your retirement account are made with pre-tax dollars and are therefore subject to taxation upon withdrawal. To protect against the risk of a higher taxes in retirement negatively impacting your retirement savings, contribute to a Roth account to diversify your tax risk.