

An Alternative Retirement Plan: The Roth 401(k)

Carol M. Bushnell, CPA

The Economic Growth and Tax Relief Reconciliation Act of 2001 provided a new way to save for retirement. As of January 1, 2006, employers can offer their employees the option of investing in a Roth 401(k) in addition to, or instead of, a traditional 401(k).

This is a tremendous opportunity for anyone who thinks they will be in the same, if not higher, tax bracket after retirement as they are now. This could very well be most of us; the government will likely raise taxes as Social Security and Medicare coffers dwindle, and the budget deficit grows.

Contributions

Unlike a traditional 401(k) where contributions are made with pre-tax dollars, contributions to a Roth 401(k) are made after-tax. Contribution limits are the same for both – \$15,500 for 2007 plus an additional catch-up contribution of \$5,000 for those 50 or older (much greater than the IRA limit of \$4,000 and a \$1,000 catch-up).

You cannot combine the two limits and contribute a maximum amount to each type of 401(k). However, you can split contributions between the two.

The Roth 401(k) doesn't provide an opportunity to save more of your earned money, but does provide a way to save taxes on its growth. Contributions to a Roth 401(k) grow tax-free, while those made to a

regular 401(k) grow tax-deferred. Depending on how long you have until you retire, you could have the opportunity to accumulate a tremendous amount of tax-free money.

For instance, let's assume you are 50 years old and have twenty years before you need to tap your retirement funds. If you contribute \$20,000 a year in equal monthly contributions of \$1,666, and have an annual return of 8%, at the end of twenty years you will have close to \$1,000,000 – all of which can be withdrawn tax-free! You will have only paid taxes on the \$400,000 that you contributed; assuming a 28% tax bracket, you will save about \$165,000 in taxes on the \$600,000 of growth.

Younger people have it a lot easier. A thirty-year-old would only have to contribute \$5,000 a year for twenty years in order to accumulate \$1,000,000 by age seventy – \$900,000 of tax-free money!

There are no income limitations for contributing to a Roth 401(k). In comparison, there are limitations for Roth IRAs – married couples with more than \$160,000 in adjusted gross income, and singles with more than \$110,000 cannot contribute to Roth IRAs.

Employer matching contributions must be put into a regular 401(k) account with pre-tax dollars, and taxed as ordinary income when withdrawn.

Distributions

Like regular IRAs and 401(k) plans, whether you need to or not, minimum withdrawals are required at age 70 ½ for a Roth 401(k) – this is where a Roth IRA has the advantage because there are no requirements to take distributions.

There currently is a loophole that the IRS is sure to address – the proposed regulations allow a rollover



from a Roth 401(k) into a Roth IRA. This would ultimately eliminate the minimum distribution.

The loophole, therefore, allows one to grow his or her 401(k) tax-free for as long as anyone wishes. Should a spouse inherit the Roth IRA, it can be rolled over into his or her own Roth IRA, and continue to grow – tax-free.

Withdrawals are not taxed as long as the participant is at least 59 ½ years old, and five years have passed since the first contribution. Also, as in a regular 401(k), qualified distributions can also be made in the following situations.

- Disability
- Qualifying first-time home purchase
- Upon death of the contributor

Employer's Options

Section 403(b) plans offered by non-profit and educational employers are also eligible to add Roth accounts. However, 457 plans offered by the government are not allowed the option.

Employers are not obligated to offer a Roth 401(k), and many probably won't. In order to establish the Roth option, the 401(k) plan needs to be formally amended. In addition, the Roth 401(k) contributions and earnings will have to be maintained in a separate account from the regular 401(k). The plan administrator will be required to allocate gains, losses, and fees among the separate accounts, and this additional accounting will be required until all Roth contributions have been distributed. Certainly, employers can expect an increase in administrative fees.

In addition, employers may be somewhat reluctant to offer yet another option to their employees, anticipating confusion and an increased lack of participation due to employees having to decide between the two alternatives.

Many employers will take a "wait and see" attitude. If employees show an interest, the employer will most likely do the right thing and offer the plan. However, if your employer chooses not to amend, there is nothing you can do. Employees cannot elect to make after-tax Roth contributions without a plan amendment.

Conversions

As you probably know, since 1998, depending on your income level, you have been able to convert a regular IRA into a Roth IRA and pay tax on the amount converted. Unfortunately, the proposed regulations currently do not allow the conversion of a regular 401(k) into a Roth 401(k).

Limited Time Offer

The new Roth accounts were authorized by Congress back in 2001 and, like most provisions of that tax act, they expire in 2010. Congress may extend the option, especially if the plans are popular, but there is no guarantee that they will. Any monies contributed to the plan up until 2010 will continue to grow tax-free. However, no further contributions will be allowed.

The Bottom Line

The Roth 401(k) will open many windows of opportunity. If you are unsure how it can benefit you, give us a call. We can provide the information you need to make the right decisions for your retirement savings.

Your Best Financial Resource in a Changing World

*Thomas G. Ambrosi, CPA, MST, CVA, PFS • Michael A. Donahue, CPA, MST • Keith N. Congdon, CPA
Karin M. Wilks, CPA, MST • Carol M. Bushnell, CPA • Robert A. Poirier, CPA
Linda A. Blake - Paralegal/Financial Services • Robert W. Cleary, MBA - Payroll Services*

Ambrosi Donahue Congdon & Co., P.C.

One Harris Street, Newburyport, Massachusetts 01950 USA • Phone 978.462.6674 • Fax 978.465.4756 • email cpa@adccpa.com • www.adccpa.com