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# the EDUCATED INVESTOR

FEATURE ARTICLE

## The Roth 401(k)

**Overview:** With the passage of the Pension Protection Act of 2006, Roth 401(k)s have become a permanent option to 401(k) plans. This article discusses what a Roth 401(k) is, how it differs from a traditional 401(k) and a Roth IRA and how the Roth 401(k) can provide additional benefit to investors.

### What is a Roth 401(k)?

A Roth 401(k), recently added as an option to 401(k) plans, allows investors to contribute to their 401(k) plan with after-tax dollars and grow their money tax-free. A Roth 401(k) is not a separate account, but rather a potential option within a 401(k) plan. Withdrawals are not taxed provided the withdrawal is a qualified distribution, meaning the account has been held for at least five years and the distribution is made after turning 59½, due to disability, or by an account beneficiary after death of the account owner.

### Roth 401(k)s Gaining Popularity

The number of companies offering the Roth 401(k) option should continue to grow, after the Pension Protection Act of 2006 made the offering permanent. According to a survey by Deloitte Consulting, LLP conducted before the Act's passage, nearly one-third of companies listed the uncertainty around the account option as the reason Roth 401(k)s were not offered to employees. Those companies could join the 30 percent of those surveyed that indicated they planned to offer Roth 401(k)s to employees.<sup>1</sup>

### How Does a Roth 401(k) Differ from a Traditional 401(k)?

Some of the more important distinctions between Roth 401(k) and traditional 401(k) accounts include:

- Investors make Roth 401(k) contributions on an **after-tax** basis, which means that investors pay taxes up-front. Investors make traditional 401(k) contributions on a **pre-tax** basis, which means they do not pay taxes until they take qualified distributions.
- Because taxes on contributions to a Roth 401(k) are paid up-front, qualified distributions from a Roth 401(k) are tax free whereas qualified distributions from a traditional 401(k) are taxed at ordinary income tax rates.

- Roth 401(k) accounts are eligible for rollover distributions into Roth IRAs upon retirement or separation from employment. Traditional 401(k) accounts, on the other hand, must be rolled into regular IRAs. Since Roth IRAs are not subject to Required Minimum Distributions (RMDs) like regular IRA accounts, retirees can avoid taking RMDs on Roth 401(k) dollars that are rolled into Roth IRAs. Over time, this could result in more **after-tax** wealth.

### **How Does a Roth 401(k) Differ from a Roth IRA?**

Some of the more important distinctions between a Roth 401(k) and a Roth IRA include:

- The maximum annual contribution to a Roth IRA is \$4,000, or \$5,000 for individuals 50 and older. Annual contributions to a 401(k) account can be split between Roth contributions and traditional contributions, but the combination cannot exceed \$15,500, or \$20,500 for employees 50 and older (the 2007 IRS maximum 401(k) contributions).
- Couples who earn more than \$160,000 of modified Adjusted Gross Income (AGI) and individuals who earn more than \$110,000 of AGI cannot contribute to Roth IRAs. However, 401(k) accounts do not have income limits, so employees can contribute to both Roth 401(k) and traditional 401(k) accounts regardless of income.

### **Tax Considerations**

Two important tax factors come into play when considering distributions to a traditional 401(k), Roth 401(k) or both: current income tax brackets and future tax brackets.

Investors expecting to be in a lower tax bracket when withdrawing from their 401(k) may favor traditional 401(k) contributions. Those investors would avoid paying income tax on the contributions and have a comparatively favorable tax bill on the distributions. An example would be investors who are at the peak of their earning potential and expect to pay lower taxes in retirement.

Conversely, investors expecting to be in a higher income tax bracket when receiving distributions may favor Roth 401(k) contributions. Those investors would pay their tax bill on their contributions at a lower rate, then make their withdrawals tax free and avoid paying higher income taxes. An example would be younger investors who have a long time before retirement and who expect their income (and income tax bracket) to rise with time.

However, the tax landscape can change at any time. Maybe taxes will decline as people are encouraged to spend. Maybe taxes will increase to cover rising Medicare, Medicaid and Social Security costs. Investors can make contributions to both traditional and Roth 401(k)s to help hedge against an uncertain tax future. Also, employer contributions to 401(k) accounts are made with pre-tax dollars. This includes profit sharing and matches to employee contributions, so employees contributing to a Roth 401(k) and taking advantage of a company match, for example, would have both taxable and tax-free withdrawals available at retirement.

### **Conclusion**

The introduction of the Roth 401(k) is a particularly exciting development for investors as it gives them more options when planning for retirement. Properly incorporating Roth 401(k) distributions into a retirement plan can give investors more tax flexibility in retirement, creating the potential for higher after-tax wealth.

<sup>1</sup> **Annual 401(k) Benchmarking Survey.** Deloitte Consulting, LLP, 2006.