Is the Roth 401(k) Right For Me?
Tax Planning Issues Drive Roth 401(k) Decision

The world is abuzz right now with the new Roth 401(k). We're excited as well - any and all enhancements to allow for retirement savings is a welcome addition to the landscape. However, we're concerned that a far too simplistic review of the Roth 401(k) has been taking place. Our analysis is that most Americans would be better off with a traditional, tax-deductible 401(k). Even for high-income folks who might be tempted by the lure of tax-free distributions during retirement, the decision is not an easy one. Our guidance is to look before you leap! In order for the Roth 401(k) to make sense, several key assumptions must have to work out. Among the key assumptions? The future of Federal tax rates. We're hoping that by reviewing this paper, you'll be better able to determine if the Roth 401(k) is right for you.

A Quick History of The Roth 401(k)

Before we begin crunching some numbers to help you better understand the merits of the Roth 401(k), let's consider a brief history of how it came to be.

In 2001, a momentous piece of legislation was passed called the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Among the over 400 new tax rules that were passed was the provision that gave rise to the Roth 401(k). Modeled after the Roth IRA, which has been around for almost 10 years now, all contributions and earnings going into a Roth 401(k) can be withdrawn free of income taxes. With traditional IRAs and 401(k) contributions, taxes are paid on withdrawals during retirement. As is also the case with the Roth IRA, no tax deduction is taken for contributions to the Roth 401(k).

The Roth 401(k), however enjoys a couple of key advantages over a Roth IRA:

- No income restrictions are imposed on Roth 401(k) eligibility as is the case with the Roth IRA
- Much higher contribution limits - $20,000 in 2006 compared to $5,000 for a Roth IRA.

So, when it comes to a decision between a Roth IRA or a Roth 401(k), the answer is the Roth 401(k) because it allows you to sock away more for retirement. (Keep in mind that if you can afford it and qualify for the Roth IRA, you can do both and put away $25,000). The real question, of course, is deciding between a Roth 401(k) or a Traditional 401(k)?

Predictions and Assumptions vs. A Bird In The Hand

Making a choice between a traditional 401(k) or a Roth 401(k) is a function of two key issues:

(1) The Basic Math – Is the Roth 401(k) really better and, if so, what are the key assumptions behind the math?

(2) A Prediction of Future Federal Tax Rates

Now, let's get under the hood and try and provide some clarity. As a starting point, let's assume that we have a 50 year old contributing $20,000 to a traditional 401(k) or the Roth 401(k). The $20,000 contribution compounds for 20 years at 8% (Assumption #1). This example also assumes that the taxes due on the Roth contribution do not come from the Roth contribution (Assumption #2) and are instead paid from another source. We've also assumed a 28% tax rate upon retirement (Assumption #3). Based on these assumptions, the Roth 401(k) is the clear winner – producing an extra $20,501 in income. The results can be seen in Exhibit 1.

Aha, you might be saying. What if none of these assumptions actually work out? Great question. And since you've asked, let's try this exercise again but change the investment return to 6% and assume that the tax rate upon retirement (and distribution from the accounts) rises to 33%. Once again, the Roth 401(k) reigns supreme with an extra $14,567. (see Exhibit 2 on next page)

Obviously, there are many iterations of this exercise and Exhibit 3 (see next page) gives you a summary of several different combinations of assumed investment returns and future tax rates upon retirement. Please note that we have not assumed investment returns greater than 8% for two reasons: one, we don't think the markets will deliver it long-term and two, it's not prudent planning to assume blue skies. As you can see from Exhibit 3, the Roth 401(k) is the better choice in all scenarios.

Exhibit 1:
Equal Contributions, 8% Return, 28% Tax Rate

	Pre-Tax Traditional 401(k)	Roth 401(k)
Salary Contribution	$20,000	$20,000
Federal Tax on Contribution (paid today at 28%)	$0	$5,600
20th Year Account Balance @8% Rate of Return	$93,219	$93,219
Taxes Due Upon Distribution (28% tax rate)	$20,501	$0
After-Tax Retirement Income	$72,718	$93,219
Extra After-Tax Income	$0	$20,501

Exhibit 2:
Equal Contributions, 6% Return, 33% Tax Rate

	Pre-Tax Traditional 401(k)	Roth 401(k)
Salary Contribution	$20,000	$20,000
Federal Tax on Contribution (paid today at 28%)	$0	$ 5,600
20th Year Account Balance @6% Rate of Return	$64,143	$64,143
Taxes Due Upon Distribution (33% tax rate)	$14,567	$0
After-Tax Retirement Income	$49,576	$64,143
Extra After-Tax Income	$0	$14,567

Exhibit 3: Equal Contributions & Various Return and Tax Assumptions

Extra Retirement Income From A Roth 401(k) vs. Traditional 401(k)
$20,000 Contribution

	Tax Rate Upon Retirement				
Investment Return	**15%**	**23%**	**28%**	**33%**	**39%**
8%	$10,983	$16,840	$20,501	$24,162	$28,555
7%	$8,609	$13,201	$16,070	$18,940	$22,384
6%	$6,621	$10,153	$12,360	$14,567	$17,216
5%	$4,960	$7,605	$9,258	$10,912	$12,896

So, if the Roth 401(k) is superior even when retirement tax rates are lower than today and in a low investment return environment, why are we saying that it still may not be the right choice for everyone? The answer lies with one of the key assumptions we've used so far in our analysis. We referred to it earlier in Exhibit 1 as Assumption #2. We assumed that the taxes due on the Roth 401(k) contribution are paid from another source and not deducted from the Roth 401(k) contribution. This is a very iffy assumption for many individuals because it is the tax-deductibility of the traditional 401(k) that makes saving possible in the first place. If the individual cannot afford both the contribution to the Roth 401(k) and the taxes, then the traditional 401(k) is really the only option. In essence, a $20,000 Roth 401(k) contribution really costs $25,600 – the $20,000 and the $5,600 in taxes on the income received (28% tax bracket).

Given the tax associated with choosing to contribute to a Roth 401(k) in lieu of a traditional 401(k), how do the numbers stack up if the taxes are netted from the Roth 401(k) contribution? Exhibit 4 provides a summary, repeating the other investment return and tax rate assumptions from Exhibit 3 (see next page).

As you can see, when the taxes due are deducted from the Roth 401(k) contribution, the Roth 401(k) rarely works out better and only when <u>(1) the assumed retirement income tax bracket has risen from current levels and (2) the rate of return is 7% or more.</u>

In conclusion, the Roth 401(k) is an

Exhibit 4: Taxes Deducted From Roth 401(k) Contribution

Extra Retirement Income From A Roth 401(k) vs. Traditional 401(k)
$20,000 Traditional Contribution; $14,400 Roth 401(k) Contribution

	Tax Rate Upon Retirement				
Investment Return	**15%**	**23%**	**28%**	**33%**	**39%**
8%	($15,118)	($9,261)	($5,600)	($1,939)	$2,454
7%	($13,061)	($8,470)	($5,600)	($2,730)	$713
6%	($11,339)	($7,807)	($5,600)	($3,393)	($744)
5%	($9,899)	($7,253)	($5,600)	($3,947)	($1,963)

excellent new addition to the retirement plans world. The decision to use a Roth 401(k) versus the traditional, tax-deductible 401(k), however, must be carefully thought through. Here's a quick checklist that will help you determine which option is better for you:

1. If you can afford to make the full Roth 401(k) contribution and pay the taxes from another source, then the Roth 401(k) is the better option.

2. If you believe your income tax rate will be higher upon retirement, the Roth 401(k) is the better option if you earn high rates of return.

3. If you need the tax-deduction now and otherwise would not be able to fully fund a Roth 401(k), then the traditional 401(k) is better

4. If you believe that you will not need either your 401(k) or your Roth 401(k) for retirement income, then the Roth 401(k) is the better choice due to the fact that it does not have mandatory "required minimum distributions." Read the sidebar on "Stretching Your IRA Over Multiple Generations" for more information on this benefit of the Roth IRA.

Will Federal Income Taxes Rise? You Decide.

Deciding if you'll be in a higher tax bracket during retirement is not easy to do. You might get there because of your efforts – you're making more during retirement than you are today. Or you might get there because of the Government's push – they might raise tax rates.

In thinking through the higher Federal tax rate issue, consider the following:

- Current income tax rates are at the lowest levels since World War II
- Taxes are the lowest as a share of GDP since World War II
- Federal spending will rise to 32% of GDP by 2050, compared to 19% today

So, if you think that income tax rates tend to be cyclical and we're at a bottom in the cycle or if you think that income tax rates will have to rise to pay for Social Security and Medicare for 76 million retiring boomers, then a Roth 401(k) may be worth considering. Unless, of course, the Government reverses the rules on tax-free distributions from your Roth 401(k)!

Stretching Your IRA Over Multiple Generations

Using Your Roth 401(k) To Provide Income For Children and Grandchildren

More and more Americans are learning about the powerful tax-planning techniques for "stretching" an IRA to provide income for three generations of beneficiaries – spouse, children and grandchildren. A Stretch IRA is a great way to leave an income legacy for beneficiaries, assuring that the money cannot be frivolously spent by receiving a lump sum.

Well, leaving a Roth IRA to beneficiaries is even better. First of all, the way you leave a Roth IRA to beneficiaries is by rolling over Roth 401(k) assets into a Roth IRA upon retirement. Upon inheriting a Roth IRA, the "Required Minimum Distribution" rules are different, allowing for less income to be forced out of the plan each year upon reaching age 70 1/2. The Roth IRA also maintains its tax-free status when passed on to heirs.

If you would like more information on Stretch IRA strategies and tax planning ideas with IRAs, please send an e-mail to INFO@RetirementDNA.com or call us toll-free at (800) 423-4891

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