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New Roth 401(k) retirement plan starts in January

By FRANCISCO A. DELGADO

There are two basic retirement programs for individuals working at private corporations: 401(k)s and IRAs. 401(k) plans are sponsored by the employers and allow employees to contribute up to \$14,000 per year, with limits increasing annually. Unlike the 401(k), an IRA is initiated by the employee and does not involve any employer activity. In contrast to 401(k)s, there is a \$4,000 contribution limit for IRAs as well as an income limit. The contribution limit will also increase biannually. Contributions to these programs may be tax deductible and could potentially reduce an individual's tax bill during year of the contribution. In regard to both IRA and 401(k) plans, the funds are taxed upon distribution. If a distribution is taken before the age of retirement, there may be an additional penalty.

Since Jan. 1, 1998, individuals have also had the opportunity to invest in Roth IRAs. Unlike typical contributions to regular IRAs, contributions to Roth IRAs are not tax-deductible. The benefit of this arrangement is that distributions after the retirement age of 59 1/2, do not incur any tax liability. An individual may have both a regular and a Roth IRA, however, there are joint limits regarding annual contributions. Essentially, it is up to the individual to decide which IRA, or IRA combination, is best for his or her retirement needs. In addition, an individual's income also has an effect on the ability to contribute to both regular and Roth IRAs. These income restrictions do not exist for 401(k) programs.

In summary, income contributed to 401(k) plans is not taxable during the year of contribution. Income contributed to IRAs is tax-deductible during the year of contribution. Effectively, contributions to 401(k) plans and regular IRA accounts are made with pretax income. The contributions to Roth IRAs, however, are not tax-deductible during the year of contribution, but are not taxed upon distribution during retirement. Additionally, there are income limits for IRA contributions, and no income limits for 401(k) programs.

The New Roth 401(k)

On March 2, the U.S. Treasury proposed the next logical progression in retirement planning: the Roth 401(k). The concept of a Roth 401(k), which goes into effect in January, is very simple. Employees of private companies would be allowed to make after-tax contributions to a company sponsored retirement program, and during retirement, have the option to either roll the plan into a Roth IRA or systematically withdraw the funds. Consequently, the distributions after retirement at age 59 1/2 will not be taxable, since the income was taxed before it entered the retirement account. The advantage of a Roth 401(k) is identical to that of a Roth IRA. Money grows tax-free and is not taxed upon withdrawal, if the withdrawal occurs during retirement. The contribution limit for Roth 401(k)'s would theoretically be combined with the

contribution limit of regular 401(k)s, (\$14,000 and increasing). Once again, individuals would need to choose which strategy is more advantageous for them. Similar to a regular 401(k), there would be no income limits to Roth 401(k) plan contributions.

The advantages of the traditional versus the Roth versions of these plans depend on three sets of variables: (i) the tax rate when the contributions and withdrawals are made, (ii) the time horizon between the contributions and the withdrawal, and (iii) the level of income during the periods of contributions and distributions. The decision varies between individuals. In principle, individuals should contribute as much as they can afford to these plans, and based on his or her personal circumstances, he or she should distinguish a plan appropriate for his or her style of living. One last difference between the two plans is that the after-tax versions have a required minimum distribution at age 70 1/2. Roth plans are more flexible because they lack this stipulation.

Additional Complications

There are two important complications with this new Roth 401(k):

- 1) With regular 401(k) plans, the employer match is also placed in the plan. With a Roth 401(k), employer matches will have to be placed in a regular 401(k) plan since they are tax-deductible for the employer. This means that the individual will pay taxes when the money is withdrawn from this employer-matched 401(k). Even if an individual finds that the best thing for him or her is a Roth 401(k), he or she will ultimately find himself or herself with both a regular 401(k), and a Roth 401(k).
- 2) There is also a sunset provision in 2010. Like most other provisions of the 2001 tax act, the Roth 410(k) would expire in 2010. That is, no new money could be contributed to the account after that date.

Francisco A. Delgado is a financial adviser with Morgan Stanley in Darien, Conn.