

Is the Roth 401(k) Right for You?

This plan could be a valuable addition to your portfolio.

Allocating your 401(k) among the funds available to you may already be a headache, particularly if your plan is subpar. But the task of managing your company-retirement plan may soon get even more complicated. Beginning in 2006, companies will be able to offer a Roth 401(k) plan in addition to the standard 401(k) plan. The Roth 401(k) stands to be a powerful addition to your investment toolkit, so even if your company doesn't plan to offer one right away, you owe it to yourself to understand what the plans are and how they work. If you fit the profile of someone who could benefit from a Roth 401(k), you can lobby your employer to add one to your company's retirement-plan menu sooner rather than later.

The Basics

If you're familiar with how a Roth IRA works, it's easy to get your arms around how a Roth 401(k) operates. As is the case with a Roth IRA, you'll contribute aftertax dollars to a Roth 401(k). The tradeoff for taking the tax hit sooner rather than later is that you'll be able to withdraw your contributions and any earnings without having to pay taxes.

That's just the opposite of the tax treatment your standard 401(k) contributions and withdrawals receive. You invest pretax dollars in a conventional 401(k) and therefore have more investment dollars working for you from the get-go, but you'll pay income tax on your withdrawals.

Other than the basic differences in tax treatment, Roth 401(k)s are quite similar to standard 401(k)s, and most companies that offer the Roth option will probably offer the Roth and standard 401(k) in tandem. (Educational and charitable institutions that currently offer 403(b)s will also be able to add a Roth option to their plans.)

There's no income limitation governing who can contribute to either type of account, and the same contribution limits that apply to a standard 401(k) will also apply to a Roth 401(k). (In 2006, you can contribute \$15,000, plus an additional \$5,000 if you're over age 50.) That limit applies to your total contributions to both accounts; that is, you won't be able to contribute \$15,000 to a Roth 401(k) and another \$15,000 to a standard 401(k). Once you've told your employer whether you want your investment dollars to go to the standard 401(k) or to the Roth 401(k) (and you may have the option to send part of each contribution to each vehicle), you'll be able to allocate your investment dollars among a menu of investment choices, most likely mutual funds. Finally, you can't withdraw your investment earnings on a tax-free basis until you reach age 59 1/2, and you'll be required to begin taking distributions from the Roth 401(k) when you're age 70 1/2, just as you have to do with a standard 401(k) plan.

Who Should Consider It

Why would someone rather pay taxes immediately, as you're required to do with a Roth 401(k), rather than defer the taxes into the future, as is the setup with a standard 401(k)? One good reason is that taxes across the board may well be higher in the future than they are now (and I think that's a pretty good bet, as the Economic Growth and Tax Relief Reconciliation Act [EGTRRA] of 2001 had some pretty generous provisions, many of which are

set to expire in 2010). If that's the case, you're better off taking the tax hit now than you are later, when taxes are higher.

Moreover, your own profile could make the Roth 401(k) preferable to a traditional 401(k). If you expect to be in a higher tax bracket when you retire than you are right now, it's obviously better to pay tax on that money at your current lower rate than it is to pay taxes when you're in a higher income bracket in the future.

Of course, I'll be the first to concede that it's difficult to forecast your future income, particularly if retirement is 10 or more years off. But if you're just starting out in your career and expect your earnings to ramp up rapidly in the future, you may be better off contributing to the Roth 401(k) and taking the tax hit now than you are paying taxes on withdrawals from a standard 401(k) when you're in a higher income-tax bracket down the road. And if you have a long time horizon until retirement, the Roth 401(k) could also be preferable to a standard 401(k) because you won't be taxed on your investment earnings, which may grow to be an impressive sum over time.

Although a Roth 401(k) may well make sense for you if you're just starting out, it's probably an even better bet if you're further along in your career and pulling down a substantial salary; perhaps you've been funding your standard 401(k) plan up to the limit, but you earn too much to contribute to a Roth IRA. (If your income exceeds a certain threshold--more than \$110,000 if you're single and more than \$160,000 if you're part of a couple who files jointly--you cannot contribute to a Roth IRA.) If that's the case, you'll probably find it beneficial to take advantage of the Roth 401(k) and the tax-free withdrawals that these plans afford. Even if you have no idea whether your income level and tax bracket in retirement will be higher or lower than they are now, the Roth 401(k) provides a good opportunity to hedge your bets: You'll pay some taxes now (on the Roth 401(k)) and some later (on the money you withdraw from your standard 401(k)).

What to Watch Out For

So, you're wondering, where do I sign up? Not so fast. The Roth 401(k) is apt to be appropriate for savers in many situations, but it's not for everyone. In particular, employees who don't expect to stash away a substantial sum for retirement (and unfortunately, many people fall into that category) will almost certainly be better off in a standard 401(k), as their income levels in retirement are apt to be lower than they were in their working years. And while your contributions to a conventional 401(k) reduce your taxable income on a dollar-for-dollar basis, that's not the case for the Roth 401(k). That means that if you divert new contributions to a Roth, and thereby have a higher taxable income, you may no longer qualify for some credits and deductions that you were eligible for in the past.

Employees mulling future Roth 401(k) contributions should also bear in mind that the Roth 401(k) provision is set to expire in 2010 unless Congress takes further action to keep it alive. That sounds ominous, but an expiration of the Roth 401(k) would simply mean that employees wouldn't be able to make fresh contributions to their Roth 401(k)s; the existing money would stay in the account and withdrawals would still be tax-free.

