

## Roth 401(k)

## Tax-Free Allure

By Jonathan E. Lederer, CFA

**M**ost business owners have heard about the new Roth 401(k), but many have yet to incorporate this retirement plan option. They may be depriving their employees of a productive means of generating more after-tax income in retirement.

That said, the Roth 401(k) may not fully benefit everyone, as those who foresee their tax rates falling and those with the discipline and financial capacity to invest tax savings from pretax contributions may be better off in a traditional 401(k) plan.

**How It Works**

The Roth 401(k) is very similar to the Roth IRA in that plan participants contribute aftertax money (i.e., contributions do not reduce

taxable income) but can withdraw funds tax-free after age 59½ if they have held the account for at least five years. These characteristics are in stark contrast to traditional 401(k)s and IRAs, where investors contribute funds on a pretax basis but must pay taxes on distributions. Investments grow tax-free in both traditional and Roth accounts.

Roth 401(k) participants may contribute up to \$15,000 in 2006. Those older than 50 may contribute an extra \$5,000 this year in “catch-up” provisions. These contribution limits gradually increase through 2010, at which time the provisions of the Roth 401(k) law, passed in 2001, expire. Though most observers expect Congress to extend the law, Roth participants will no longer be able

to contribute to their funds should Congress not act. In this scenario, funds already invested could still grow and be withdrawn tax-free.

Roth 401(k)s may be rolled over into Roth IRAs but may not be rolled into a qualified retirement account such as a traditional 401(k) or IRA. Obviously, the biggest advantage of the Roth 401(k) is the tax-free distribution status. Since rising fiscal deficits do not appear to be subsiding, tax rates could very well increase in the future. Thus, the ability to eliminate taxes on future distributions is certainly a key selling point for the Roth.

For high-wage earners, the Roth 401(k) introduces a means for tax-free distributions, as many of these high earners are ineligible for Roth

## The New Roth 401(k) vs. The Traditional 401(k)

\$15,000  
\$20,000 if over 50

“Naah!”

“Yeah, baby!”

“Yeah, baby!”

None if rolled over  
into Roth IRA

“Yeah, baby!”

(Roth IRA rollover)

2006 employee contribution limit

Contributions reduce taxable income

Tax-free distributions...

after age 59½ and 5 years of account ownership

Investments grow tax-free

Mandatory distributions at age 70½

Tax-free transfers to heirs

\$15,000  
\$20,000 if over 50

“Yes, of course.”

“No, thank you.”

“Yes, certainly.”

“Yes, certainly.”

“No, thank you.”