The New Roth 401(k) Plan

A new retirement account was signed into law on August 17, 2006. It is a component of a "regular" 401(k) plan; however, the funding of a "Roth" 401(k) plan is with **AFTER-TAX** dollars. This is similar to the Roth IRA but with higher funding limits and no limit on earnings to contribute. Money contributed to a Roth 401(k) plan **grows without tax** and is **distributed without tax**. For 2009, of which you have until April of 2010 to contribute, the funding limit is $16,500, or $22,000 if over the age of 50.

Ask yourself the following question: Will you grow more wealth funding a Roth 401(k) in a non-deductible manner where the money grows then comes out income tax free, or will you grow more wealth income-tax deferring money into a traditional 401(k) where the money withdrawn is **fully income taxable** at your current income tax bracket?

The answer is… it depends. Since I know people purchased this book for the "answers" and real math, the real world answer about Roth plans is that the vast majority of readers will in fact be better off using Roth plans over traditional income tax deferred plans.

Who should use a Roth 401(k)?

-Anyone who will be retiring in the same or higher tax bracket.

-Anyone who will be retiring in a tax bracket within 10% of their current tax bracket.

For example, if you are in the 40% tax bracket and will retire in the 30% tax bracket, using a Roth plan is still a better financial tool than using a traditional tax deferred retirement plan.

Examples are really the best way to show the benefits of a Roth plan and when it is appropriate to use one. The material that follows will illustrate the economics of a Roth 401(k) plan for a reader who is in the 40%, 30% and 15% tax brackets when both contributing to a Roth 401(k) and when removing money from it income tax free in retirement.

A Roth 401(k) plan is being used in the example because I want to illustrate using a $15,000 contribution, which is well in excess of the contribution limit for a Roth and traditional IRA.

For this example, assume the client, Mr. Smith, age 45, contributes $15,000 to a Roth 401(k) plan each year for 20 years and takes distributions from the plan from age 66-85.

Because the annual contribution is nondeductible, Mr. Smith would have to pay the following taxes on his contribution to the Roth 401(k), depending on his income tax bracket:

$15,000 x 40% = $6,000 in taxes
$15,000 x 30% = $4,500 in taxes
$15,000 x 15% = $2,250 in taxes

Assume <u>7% investment returns</u> over the life of the plan.

The goal of these types of examples is to compare how much money a person would have after tax each year during retirement with a Roth 401(k) plan and with a traditional 401(k) plan.

For an appropriate comparison between a Roth plan and a traditional tax-deferred plan, I need to address the tax deductibility of the contribution into a traditional tax-deferred plan.

IF Mr. Smith funded a <u>traditional</u> 401(k) plan with $15,000, he would have saved taxes, as shown earlier ($6,000 in the 40% tax bracket, $4,500 in the 30% tax bracket and $2,250 in the 15% tax bracket).

Therefore, to run an apples-to-apples comparison, I will allow:

1) $15,000 to grow tax free and be withdrawn tax free from the Roth 401(k) plan.

2) $15,000 to grow tax-deferred in the traditional 401(k) plan (taxable when withdrawn).

3) $6,000, $4,500 and $2,250 to be invested into a taxable <u>side fund</u> for the traditional 401(k) plan. (The amounts are different because I am going to show three different examples for clients in different income tax brackets.)

When readers actively invest money in the stock market in taxable side funds, capital gains and dividend taxes must be taken into account. The following are the assumed annual blended tax rates for the side fund.

-25% for the client in the 40% tax bracket
-20% for the client in the 30% tax bracket
-15% for the client in the 15% tax bracket

Finally, to make this more of a real world example, I will also add in an annual mutual fund expense of **<u>0.6%</u>** annually on the money as it grows (the average annual mutual fund expense is approximately 1.2%).

How much can Mr. Smith expect to receive in retirement from his **<u>Roth</u>** 401(k) plan?

<u>$56,541</u> from the plan income-tax free every year for 20 years (66-85).

If Mr. Smith instead funded a **<u>regular taxable</u>** 401(k), the following is how much the client could receive from ages 66-85 after-tax:

-$33,925 in the 40% tax bracket
-$39,579 in the 30% tax bracket
-$48,060 in the 15% tax bracket

The **previous numbers must be added to the side account** that Mr. Smith would have funded with the extra dollars he would have saved in income taxes when he funded a deductible 401(k) plan.

From the side account, he could receive the following amounts after taxes from ages 66-85.

-$16,533 in the 40% tax bracket
-$13,206 in the 30% tax bracket
-$7,031 in the 15% tax bracket

Totaling the numbers:

If I add the regular tax-deferred 401(k) **plus the taxable side account**, Mr. Smith would receive the following from ages 66-85:

-$50,458 in the 40% tax bracket
-$52,785 in the 30% tax bracket
-$55,091 in the 15% tax bracket

Since Mr. Smith would receive **$56,541** from a Roth each year, he would be better off with a Roth regardless of his income tax bracket.

Manipulating the numbers

What if Mr. Smith starts in the 40% income tax bracket and then drops down to 30% income tax bracket in retirement?

He could then take out **$57,642** over the same time period. This is a combination of his taxable 401(k) **and his** taxable side fund.

What if Mr. Smith started in the 30% income tax bracket and then dropped down to the 15% income tax bracket in retirement? **$62,569.**

What if Mr. Smith started in the 40% income tax bracket and then dropped down to the 15% income tax bracket in retirement? **$66,123.**

What if Mr. Smith started in the 30% income tax bracket and then went **UP** to the 40% income tax bracket in retirement? **$48,434.**

As you can see, the Roth 401(k) plan does slightly worse when a client moves from a 40% income tax bracket to a 30% income tax bracket, much worse with a drop from a 30% bracket to a 15% bracket, and even worse yet when dropping from a 40% bracket to a 15% bracket (because the client is lowering his tax bracket in retirement the Roth is not nearly as helpful).

It is interesting to note what happens when a client moves up in tax brackets in retirement. When a client goes from 30% to 40%, the client does significantly better with a Roth 401(k) plan than a regular 401(k) plan ($56,541 from the Roth and only $48,434 from the traditional 401(k) plus the taxable side fund).

