A New Way to Accumulate Wealth & Reduce Taxes

By

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New legislation will come into effect in January 1st, 2006 which includes a new employer sponsored retirement plan – the ROTH 401(k).

Already, it is attracting criticism as being for the rich only due to its tax-reducing capabilities. And there is no doubt that for the tax savvy investor there are advantages. So how does it work?

What is the difference between a 401(k) plan and the new ROTH 401(k)?
If you are contributing to your company's 401(k) plan, those contributions are made with pre-tax dollars. While your money is in the account and accumulating it is not taxed, but it is taxed as ordinary income on every dollar you take out. Your contributions to a ROTH 401(k), if you should decide to make them, are made with after-tax dollars. Initially, it will not make any difference to your tax bill. However, contributions and earnings can be withdrawn tax-free after age 59½. Prior to age 59½ any withdrawals may be subject to income tax of the earnings and a 10% IRS penalty tax. Therefore, it does give you more control over taxable income in retirement. Also, from a historical perspective tax rates are currently low, if they increase over the next 20 to 30 years it gives you an opportunity to lock in today's tax rate.

Which plan will offer the biggest tax break?
That depends on three factors: how long your money stays in the account, how much it earns and your tax rate when you put in and take it out. The ROTH 401(k) definitely benefits those who expect to be in a higher tax bracket after retirement.

Can I contribute to both?
Yes, but the most you will be allowed to contribute to a 401(k) plan is $15,000 – the same limit will apply to the new ROTH 401(k). Combined the limit is still $15,000. (Another $5,000 if you are 50 or older in catch-up contributions.) Many wealthy investors were hoping that the new ROTH would allow them to save more for retirement. But not so, the only advantage is that you can contribute more after-tax dollars. The current legislation limits investments to $4,000 per year into a ROTH IRA (or $5,000 if you are 50 or older) plus if your adjusted gross income is over $160,000 for married couples or $110,000 for singles you are not allowed a ROTH contribution. It could be a good fit for you if you are younger employee who is currently paying lower federal taxes due to large tax deductions for childcare and homeownership. If you expect your salary to increase aggressively, there is a likelihood that your income in retirement may be taxed at a higher rate than it is now.

Will I be able to switch some of my money from my 401(k) into a new ROTH 401(k)?
No, you can only contribute to one or both types of accounts. If your employer is making a matching contribution, it must be put into a 401(k) plan even if you are directing all of your contributions to a ROTH 401(k) plan.

The opportunity to contribute to a ROTH 401(k) may not be around forever. The legislation is scheduled to end after 2010 unless Congress acts to extend it. If it is not extended the money in your plan would stay there but you would not be able to make new contributions.

On a final note: Like all retirement plans your contributions to a ROTH 401(k) must be invested appropriately to reflect you timeframe and investment risk tolerance.

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