

The Roth 401(k) – A New Twist On An Old Technique, But Does It Make Cents?

A traditional 401(k) allows an employee to contribute pre-tax earnings into an account where they grow free from tax until distributions are received from the account, at which time, all of the distributions are taxable to the recipient. A Roth 401(k) allows an employee to contribute post-tax earnings into an account where they grow free from tax until distributions are received from the account, at which time, none of the distributions are taxable to the recipient. A simpler explanation of the distinction is with a Roth 401(k), the employee pays the tax now and, with a traditional 401(k), the employee pays the tax later.

The Roth 401(k) was created by the 2001 Tax Act although it does not go into effect until January 1, 2006. Because it was created by the 2001 Tax Act, it is subject to a sunset provision. Consequently, unless Congress acts, contributions to Roth 401(k)s will not be permitted after 2009.

Although the Roth 401(k) may be around for only a limited amount of time, it may be a financially attractive alternative to a traditional 401(k). In the examples set forth below, I assume that Congress acts and extends the life of Roth 401(k)s indefinitely. Had I assumed that contributions to Roth 401(k)s were not permitted after 2009, as the current statute provides, the results would favor the same technique but would be less dramatic.

Mr. Roth wants to allocate \$15,000 of his pre-tax earnings to a qualified retirement plan and he wants to contribute to a Roth 401(k). Because contributions to a Roth 401(k) are made after tax, Mr. Roth will first need to pay \$4,200 on the \$15,000 of earnings, at a 28% rate. Then, Mr. Roth will contribute annually the remaining \$10,800 to his Roth 401(k) for thirty years. Assuming 8% growth rate and considering the fact that the distributions from the Roth 401(k) will not be subject to tax, at the expiration of thirty years, Mr. Roth will have \$1,321,355.

Assume that Mr. Traditional allocates \$15,000 of his pre-tax earnings to a traditional 401(k). Because contributions to such plans are made pre-tax, Mr. Traditional will contribute \$15,000 annually for thirty years. At a growth rate of 8%, that will grow to \$1,835,188 in thirty years. If he is in a 28% tax rate at that time, after the tax on the distributions is paid, he will be left with the same amount as Mr. Roth. If the tax rates at the time of contribution and at the time of distribution are constant, the net result will be the same so long as the amount of the pre-tax contribution is the same and is less than or equal to the 401(k) contribution. When the amount of the annual pre-tax earnings allocated to a Roth 401(k) exceeds the contribution limit to such a plan, the result is quite different.

Contributor 1, Mr. Roth, contributes \$15,000 to a Roth 401(k) at the beginning of every year for thirty years. However, the cost to Mr. Roth is more than the amount of the actual contribution because the amount contributed creates income to him at the time of

contribution. Mr. Roth needs to allocate earnings of \$20,833, at a 28% federal tax rate, to have \$15,000 after tax to contribute to the Roth 401(k). However, if Mr. Roth's contributions grow at 8% per year, at the end of thirty years, he will have an account with \$1,835,188. Recall that when he takes distributions, neither the contributed amounts nor the earnings on them are subject to tax.

Contributor 2, Mr. Traditional also wants to allocate \$20,833 to his retirement plan. He contributes \$15,000, the maximum allowed for 2006, to a traditional 401(k) at the beginning of every year for thirty years. The contributions do not result in income to him because they are made pre-tax. Mr. Traditional must pay tax on the remaining \$5,083 of pre-tax earnings allocated to his retirement. At a 28% rate, Mr. Traditional will have another \$4,200 to invest annually at an 8% rate. After thirty years of investing \$15,000 to his traditional 401(k), Mr. Traditional will have a 401(k) worth \$1,321,335 after tax. After investing \$4,200 annually, he will also have an investment account of \$405,254 after taxes are paid on the earnings of that account. Therefore, he will have a grand total of \$1,726,589 which falls short of Mr. Roth's retirement savings of \$1,835,188 by \$108,599.

Thus, when the pretax contribution amount exceeds the 401(k) contribution limit, numerically, the Roth 401(k) is a better alternative, but this depends on two substantial assumptions. First, I have assumed that each contributor is in the 28% tax rate at the time of contribution and at the time of distribution. This is often not the case. Usually, one is in a higher income tax bracket when working than at retirement. If one were in a higher tax bracket at the time of contribution than at the time of distribution, the after tax funds may be greater using the Traditional 401(k). However, we are in a time of historically low tax rates. If tax rates were greater at retirement than at the time contributions are made, the Roth 401(k) would be an even better alternative.

Let's consider that Mr. Roth and Mr. Traditional are in the 34% tax bracket at the time of each contribution and the 28% tax bracket at the time of distribution. Now, Mr. Roth's contribution requires \$22,727 of earnings to have \$15,000 after tax to contribute. At end of the thirty year period, he will have the same balance, \$1,835,188, none of which will be subject to tax when he takes the distributions.

Mr. Traditional also allocates \$22,727 to his retirement planning. He wants to contribute the maximum to his 401(k) and invest the balance. Consequently, he contributes \$15,000 to his traditional 401(k). This amount will be excluded from his taxable earnings. After paying the tax on the balance, Mr. Traditional invests \$5,100 annually to his investment account. At the end of thirty years, Mr. Traditional will have his traditional 401(k) worth \$1,321,335 after tax and an investment account worth \$463,836, after the earnings thereon have been taxed for a grand total of \$1,785,171. This still falls short of Mr. Roth's account by more than \$50,000. Thus, even if one's tax rate is higher at the time of the contribution than at the time of distribution, a Roth 401(k) may still produce a better result.

The second assumption in each of the examples above is that Mr. Traditional is disciplined enough to invest the \$4,200 or \$5,100 each year and never touch those investments until retirement. If he misses just one contribution, his investments will fall further behind Mr. Roth in the end. Having advised people for years on financial planning, I can only name a few that have the discipline to make the annual contributions necessary for a Traditional 401(k) to match those of a Roth 401(k).

Thus, assuming that you can pay the tax bite at the time of contribution, a Roth 401(k) will likely produce a greater after tax benefit in the end. Please note that numerous assumptions were made to reach this conclusion. As always, you should obtain professional advice that considers your specific circumstances before making any retirement planning decision.

The author of this article, Joseph G. Imbriani, Esq., CPA/PFS, practices in the areas of taxation and estate planning and is a partner of the Boston law firm of Taylor, Ganson & Perrin, LLP.