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Roth 401(k) plans are gaining traction - What does it offer?

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It looks as though more and more people will have the option of using a Roth 401(k) to save for retirement. Of 429 U.S. companies included in a recent survey, 22% gave employees the choice of a Roth 401(k). Of the companies that did not offer a Roth, 61% plan to add this option.1 What does the new plan offer retirement savers?

The key distinctive feature of a Roth 401(k) is the tax treatment of contributions and distributions. In a traditional 401(k), employees invest pre-tax dollars and then pay taxes as they withdraw. In a Roth, 401(k) contributions are made on an after-tax basis and participants may take tax-free distributions at retirement, as long as certain holding requirements are met.

Like the traditional 401(k), the Roth 401(k) allows participants to make contributions via salary deferrals. Employee Roth contributions are eligible for an employer match, but all matching dollars are allocated to a pre-tax account and are not made as additions to the Roth account. Also, any forfeiture amounts credited to a plan participant are added to the traditional 401(k) account rather than the Roth 401(k) account.

There is a maximum contribution amount for all 401(k) accounts - both Roth and traditional. For the 2008 tax year, federal laws permit a maximum annual contribution of $15,500 ($20,500 for participants age 50 and older), although employers may impose a lower limit. A plan participant may make any combination of Roth and/or traditional 401(k) contributions up to that limit.

There are no income limitations on participating in the Roth 401(k).

Once a participant leaves the company, distributions from the Roth 401(k) account may be rolled over into another Roth 401(k) or Roth 403(b) or to a Roth IRA. The best choice hinges in part on how the holding requirements are affected in different accounts. In addition, Roth 401(k) participants are required to take minimum distributions on an annual basis after they reach age 70Â½.

Is a Roth 401(k) Right for You?

The central issue is the value of the tax treatment. Each individual needs to consider the benefit of receiving a current income tax deduction when contributing to a traditional 401(k) versus the benefit of contributing to a Roth 401(k) and having the potential for no taxation on future distributions from the plan. Generally speaking, the Roth 401(k) is more attractive if you think you'll end up in the same tax bracket or a higher one during retirement, and the regular 401(k) is more attractive if you think you'll end up in a lower bracket during retirement. To figure this out, you need to make assumptions about your own tax situation as well as whether personal income tax rates will rise or fall in the futureâ€”not an easy forecast.

The absence of income limitations makes the Roth 401(k) particularly attractive to individuals with adjusted gross income of over $110,000 or married couples with more than $160,000 in adjusted gross income. At these income levels, investors are precluded from contributing to Roth IRAs. Like the Roth 401(k), contributions to the Roth IRA are made on an after-tax basis and participants can take tax-free contributions at retirement.

Part of the Big Picture

Choosing between savings plans is only one piece of the retirement puzzle. A financial advisor can help you think about key lifestyle issues, how to estimate expenses in retirement, how to save enough to meet expenses and which retirement savings strategies make the most sense for you.

1 Roth 401(k) Survey 2007, Profit Sharing/401(k) Council of America (PSCA)

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