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What is the Roth 401(k)?

Beginning January 1, 2006, your employer has the ability to change their 401(k) plan to allow employees to defer after-tax dollars into a Roth 401(k) sub-account. The benefit of doing so is tax-free account growth AND withdrawals taken during retirement will not be subject to income tax. Below is some information which may help you understand the Roth 401(k) addition.

How does a Roth 401(k) work?
As part of a 401(k) plan you are able to make elective deferrals each year at a limit of $15,000 for 2006, plus a catch up provision of those 50 years of age and older of $5,000 for a total of $20,000. Until now, your deferrals have only been able to be pre-tax contributions. Now (if the plan is amended) through the Roth 401(k), your deferrals may be contributed to designated sub-accounts via pre-tax and/or after-tax (Roth 401(k)) dollars. Employer contributions may only be contributed to the pre-tax sub-account.

Pre-tax contributions are taken from your salary prior to taxes being paid, the assets grow tax deferred, and are taxed at your income tax rate when distributed to you. Roth 401(k) contributions are taken from your salary after taxes have been paid, the assets grow tax free and are distributed tax free as a qualified distribution.

Unlike the Roth IRA, the Roth 401(k) does not have an adjusted gross income limit. Therefore, all employees may contribute to the Roth 401(k) sub-account.

Distributions
Roth 401(k) accounts are subject to normal distribution restrictions on elective deferrals, such as death, disability, age 59 ½, employment termination, hardships, etc. When the distribution is qualified, the assets are distributed tax free to you. A qualified distribution is one which satisfies both a:

- Qualifying event
  - Attain age 59 ½,
  - Death, or
  - Disability, and
- 5 years participation
  - Must wait 5 years from the first calendar year that a deferral contribution is made to the Roth 401(k), however you do not need to contribute for each of the 5 years, but the time period begins when the first contribution is made.

Non-qualified distributions are subject to income tax on the earnings and a 10% penalty.

The Roth 401(k) deferrals are also subject to Required Minimum Distribution (RMD) rules starting at age 70 ½. However you may rollover your Roth 401(k) assets to a Roth IRA prior in order to avoid RMD.

Other determining factors:

- You should consider your employer's 401(k) matching program when determining how much to contribute either to the Roth 401(k) or traditional pre-tax sub-accounts.
- You must consider your individual tax situation, retirement age and income needs to determine if Roth 401(k) contributions are right for them versus contributing pre-tax dollars to their 401(k) Plan.
- The Roth 401(k) is a provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 that is set to expire in 2010. Should the provisions expire, experts say the assets will likely remain in the accounts with no further contributions being allowed.
- The Department of Labor and the IRS still have yet to finalize many regulations surrounding the workings of the Roth 401(k).

Illustration comparing investing in either the Roth 401(k) or the Traditional Pre-Tax account:

Scenario 1

The participant is age 35 and makes a salary of $50,000. The goal is to have the ***same take home pay*** whether the participant contributes to the Roth 401(k) or the Traditional Pre-tax 401(k) sub-account. The scenario also assumes a 3% salary increase per year and a 10% deferral per year.

	Roth 401(k)	**Traditional Pre-tax 401(k)**
Gross Pay	$50,000.00	$50,000.00
Pre-tax Deferral	$0.00	$5,000.00
Roth 401(k) Contribution ($5,000 minus taxes)	$3,467.35	$0.00
Net pay after taxes and contributions	***$32,793.80***	***$32,793.80***
Total 401(k) Contribution	$3,467.35	$5,000.00
401(k) Balance at Age 65 & 8% Return	$424,215.95	$611,729.34
Estimated Marginal Tax of 32%@ Age 65	$0.00	$195,753.39
Account Balance After Tax @ Age 65	**$424,215.95**	**$415,975.95**

Scenario 2

The participant is age 35 and makes a salary of $50,000. The goal is to have the ***same 401(k) contribution*** whether the participant contributes to the Roth 401(k) or the Traditional Pre-tax 401(k) sub-account. The scenario also assumes a 3% salary increase per year and a 10% deferral per year.

	Roth 401(k)	**Traditional Pre-tax 401(k)**
Gross Pay	$50,000.00	$50,000.00
Pre-tax Deferral	$0.00	$5,000.00
Roth 401(k) Contribution ($5,000 minus taxes)	$5,000.00	$0.00
Net pay after taxes and contributions	$31,261.15	$32,793.80
Total 401(k) Contribution	***$5,000.00***	***$5,000.00***
401(k) Balance at Age 65 & 8% Return	$611,729.34	$611,729.34
Estimated Marginal Tax of 32%@ Age 65	$0.00	$195,753.39
Account Balance After Tax @ Age 65	**$611,729.34**	**$415,975.95**

Scenario 3

The participant is age 52 and makes a salary of $200,000. The goal is to have the ***same 401(k) contribution*** whether the participant contributes to the Roth 401(k) or the Traditional Pre-tax 401(k) sub-account. The scenario also assumes a 3% salary increase per year and a 10% deferral per year, giving a total contribution of $20,000 including the catch up provision.

	Roth 401(k)	**Traditional Pre-tax 401(k)**
Gross Pay	$200,000.00	$200,000.00
Pre-tax Deferral	$0.00	$20,000.00
Roth 401(k) Contribution ($20,000 minus taxes)	$20,000.00	$0.00
Net pay after taxes and contributions	$106,967.25	$115,182.25
Total 401(k) Contribution	***$20,000.00***	***$20,000.00***
401(k) Balance at Age 65 & 8% Return	$464,298.41	$464,298.41
Estimated Marginal Tax of 32%@ Age 65	$0.00	$148,575.49
Account Balance After Tax @ Age 65	**$464,298.41**	**$315,722.92**