

September 6, 2006

GETTING GOING

By JONATHAN CLEMENTS



Trimming Your Taxes: Why Roth 401(k)s Often Beat Conventional 401(k) Plans

September 6, 2006; Page D1

It's time to stir things up at the office.

Thanks to the new pension law, Roth 401(k) plans are no longer slated to disappear in 2011 -- and that means a lot more companies will consider offering these plans.

Want a shot at tax-free investment growth? Here's why you should phone up human resources and put in a request for the Roth 401(k).

• **Debating rates.** Suppose you get your wish and a Roth option is added to your company's retirement plan. Suddenly, you will face a critical decision. Each year, you can make total 401(k) investments of as much as \$15,000, or \$20,000 if you are age 50 or older.

SPLIT DECISION


How to choose between a Roth and a regular 401(k):

- Favor the regular tax-deductible 401(k) if you expect to be in a much lower tax bracket in retirement.
- Opt for the Roth 401(k) if you don't expect your tax bracket to drop much, you want to make tax-free withdrawals before age 59 ½, or you plan to bequeath the account.


Should you stuff these dollars in a regular or a Roth 401(k)? The standard advice is to favor the Roth 401(k) if you expect to be in a higher tax bracket in retirement. That will mean missing out on a tax deduction today. But in return, your withdrawals in retirement will be tax-free, rather than getting dinged at a punitive rate.

Conversely, if you expect to be in a lower tax bracket in retirement, the conventional wisdom is to fund a regular 401(k). That way, you earn a tax deduction today, while you are in a high tax bracket. Sure, you will have to pay taxes on your withdrawals. But once retired, you will be in a lower bracket, so the tax bite won't be so bad.

Seem reasonable? In truth, the choice isn't quite so simple -- and the Roth 401(k) is often the better bet, even if you expect your tax bracket to fall.

• **Coming up short.** To understand why, imagine you are eligible to stash \$15,000 in your employer's 401(k), your marginal federal and state tax bracket is a combined 35%, and you also expect to be paying taxes at 35% when you tap the account 20 years from now.

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Given your 35% tax rate, you would need \$23,077 in pretax income to contribute \$15,000 to the Roth. Over the next 20 years, let's assume this \$15,000 triples in value to \$45,000. You could then cash out this \$45,000 tax-free.

What if you plunked your \$15,000 in a regular 401(k) instead? Assuming you bought the same investments, your account would also be worth \$45,000 after 20 years. Trouble is, when you cash out, you would owe 35% in taxes, or \$15,750, leaving you with \$29,250.

"Unfair example," you cry. "With the Roth, you really contributed \$23,077, or \$8,077 more."

True enough. To make the comparison fair, suppose you invested \$15,000 in a regular 401(k) and then looked to sock away an additional \$8,077 in a regular taxable account. You would have to pay 35% in taxes on this \$8,077 of income, leaving you with \$5,250 to invest. If this \$5,250 also tripled in value, you would have \$15,750 after 20 years, enough to cover the tax bill on the regular 401(k).

All even? Not quite. The problem: You will owe taxes on the investment growth enjoyed by the taxable account's \$5,250, so the money won't fully cover the tax bill on the regular 401(k) -- and thus the Roth wins.

In fact, even if your tax rate falls, the Roth can come out ahead. That's especially true if you leave your Roth untouched, so it continues growing tax-free well into retirement, says Pittsburgh accountant and attorney James Lange, author of "Retire Secure."

"If you're 11 years or more from retirement, it can be worth favoring the Roth 401(k) over the traditional 401(k), even if you expect your tax bracket to drop from 35% today to 28% in retirement," Mr. Lange argues.

• **Saving more.** The above example presumes you're a diligent saver aiming to make the maximum \$15,000 401(k) contribution. For many employees, that just isn't the case. "The typical 401(k) participant is making around \$45,000 and contributing 7% of pay," equal to about \$3,000, says David Wray, president of Chicago's Profit Sharing/401(k) Council of America.

Nonetheless, for these folks, the Roth could still be better. In theory, if employees are investing \$3,000 a year in their 401(k) and they're in the 25% tax bracket, they could save the same after-tax sum by stashing \$2,250 in a Roth 401(k).

But most people won't do the math. If they opt for the Roth account, they will probably salt away the same \$3,000, in effect saving more for retirement.

Investing in a Roth 401(k) also means paying Uncle Sam now, when the tax bill is more palatable because you're pulling down a paycheck. "Most of us are clueless as to what our tax rate is going to be in retirement," notes Christine Fahlund, a senior financial planner with Baltimore's T. Rowe Price Group. "But the one thing you know for sure is that retirees don't like to pay taxes."

The Roth 401(k) offers other advantages. Whether you invest in a regular or Roth 401(k), your employer's matching contributions will go into a regular 401(k). Result: If you fund the Roth, you get "tax diversification," with part of your portfolio benefiting if your tax rate falls and part left unscathed if it rises.

In addition, if you leave your employer and roll over your nest egg to a Roth individual retirement account, not only will you avoid required minimum distributions starting at age 70½, but you can also make tax-free withdrawals before age 59½ by tapping the account's "cost basis" -- the money you originally contributed to the Roth 401(k).

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