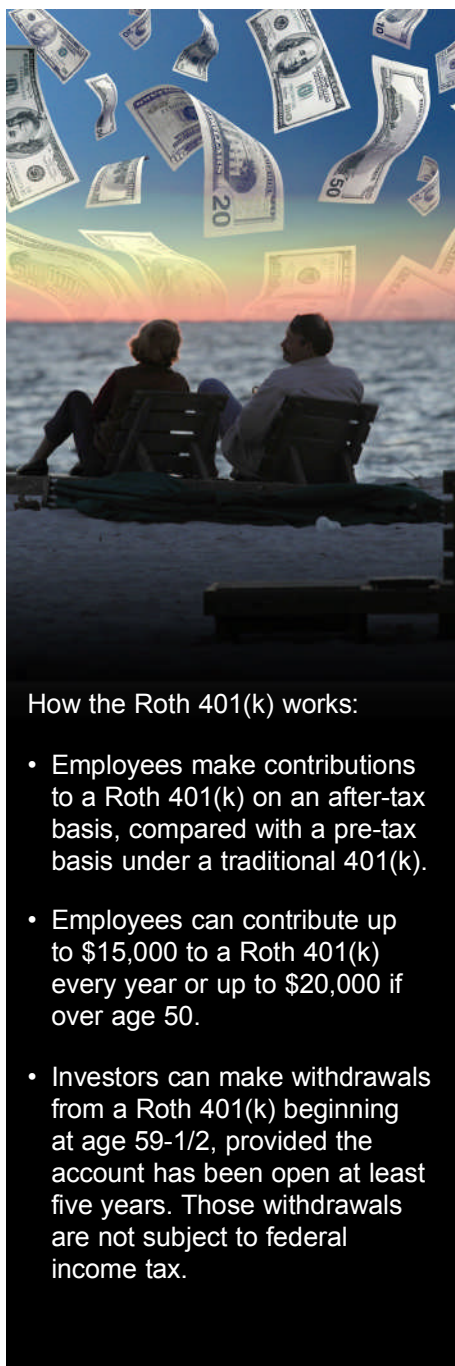


The Roth IRA is a hit with individual investors, but will it work in the workplace?



How the Roth 401(k) works:

- Employees make contributions to a Roth 401(k) on an after-tax basis, compared with a pre-tax basis under a traditional 401(k).
- Employees can contribute up to \$15,000 to a Roth 401(k) every year or up to \$20,000 if over age 50.
- Investors can make withdrawals from a Roth 401(k) beginning at age 59-1/2, provided the account has been open at least five years. Those withdrawals are not subject to federal income tax.

Investors have poured tens of billions of dollars into Roth individual retirement accounts (IRAs) since their introduction in 1997. The Roth IRA is popular with investors because it allows them to pay income taxes upfront and withdraw funds tax-free during retirement, versus socking away funds on a tax-deferred basis.

Now, for the first time, a similar retirement plan is available through employers.

The Roth 401(k), as this new investment tool is known, combines the tax advantages of the Roth IRA with the convenience of saving by payroll deduction and the benefit of a matching contribution from some employers. In addition, the income limits that restrict who can use a Roth IRA do not apply to the Roth 401(k).

For investors, tax-free withdrawals are the primary appeal of the Roth 401(k) – a way to never pay taxes again on the invested funds and any appreciation in value. But a Roth 401(k) may be more complex than a traditional 401(k).

For example, if an employee has \$9,000 annually to contribute toward retirement and is in the 25-percent tax bracket, that person could invest \$9,000 in a tax-deferred 401(k) or \$6,750 in a Roth 401(k). The \$2,250 difference goes to the IRS.

While the \$9,000 would multiply faster in the decades ahead than the \$6,750, the retiree who invests in a traditional 401(k) would still have to pay taxes when making withdrawals. If the employee falls into a lower tax bracket at retirement, the traditional 401(k) would have been the better investment. But if the employee is in a higher tax bracket at retirement, the Roth 401(k) would have been the wiser choice.

A young employee with a promising career might be smart to invest in a Roth 401(k), because future earnings will likely place her in a higher tax bracket at retirement. However, if an employee expects to be in a lower tax bracket at retirement, a regular 401(k) might be the better investment.

Predicting future tax brackets is no science, so it may make sense to consult an online calculator.

While participants might welcome a new retirement-savings vehicle, plan sponsors face a difficult choice when deciding whether to offer a Roth 401(k).

Enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, the Roth 401(k) took effect on Jan. 1, 2006. It will expire in 2010 unless Congress votes to extend it. Some companies wonder if it makes sense to add an employee benefit that may soon disappear.



In addition, the Roth 401(k) isn't easy to understand. Many employers find it difficult to explain traditional 401(k) accounts and retirement planning to employees. The Roth 401(k), with its additional tax-planning issues, adds more complexity. According to a 2005 Transamerica retirement survey, seven out of 10 Americans say they "do not know as much as they should" about investing for retirement.

Another hurdle to offering the Roth 401(k) may be its effect on nondiscrimination testing. Federal rules stipulate that highly compensated employees cannot contribute a significantly larger percent of their pay to a 401(k) plan than rank-and-file employees. If a significant number of workers sign up for the Roth 401(k) but lower their contribution amounts because they lost the traditional 401(k) tax deduction, the average percent of pay rank-and-file employees contribute could decrease relative to highly compensated employees. For example, a worker contributing \$9,000 to a 401(k) might invest only \$6,750 in a Roth 401(k) after paying 25 percent in taxes. On the other hand, highly compensated employees who can better afford to absorb the upfront taxes might contribute at the same or higher levels.

Stephen Utkus, principal at the Vanguard Center for Retirement Research, doubts many companies will face nondiscrimination testing issues due to the Roth 401(k). Since the majority of employees are in the 10 percent or 15 percent tax bracket, Utkus believes the contribution decrease won't be steep.

"It may materialize as a problem for some companies," Utkus says. "But it won't be a widespread problem."

The uncertainty hasn't stopped some companies from moving forward. About 150 of Transamerica's 16,000 small and mid-sized clients are now offering the Roth 401(k) to employees. So are a few big companies such as General Motors, A.G. Edwards and Vanguard.

Despite the complexities of the Roth 401(k), Utkus is bullish on the new offering.

"To some plan sponsors and participants, this uncertainty may foster a 'wait-and-see' approach and a delay in adopting Roth savings," Utkus writes in a Vanguard brief. "From our perspective, it suggests exactly the opposite. Given the unpredictable nature of future taxes, many sponsors and participants are likely to be better off pursuing a strategy of tax diversification with the Roth 401(k) as soon as possible."

In an interview, Utkus downplayed the complexity of the new Roth 401(k). When choosing between a Roth 401(k) and a traditional 401(k), it's really a choice between paying taxes now and paying taxes later. As a result, he predicts the rallying cry of the Roth 401(k) will be: "Never pay taxes again."

As an investment strategy, that argument is appealing for several reasons. In the past 25 years, the number of tax brackets has declined, making it less likely that an investor will fall into a lower bracket at retirement. Therefore, it makes good economic sense to "lock in" a tax rate of 10 or 15 percent, Utkus says.

Paying taxes on some investments now is particularly important for individuals and couples who are good savers. If they don't protect their retirement funds from taxes, they could take a hit during retirement.

"Why not hedge your bets and pay some taxes today?" Utkus says.

Utkus is confident Congress will make the Roth 401(k) permanent. His reasoning: With soaring budget deficits, the government needs tax revenue now.

If that happens, he predicts that 50 percent of plan sponsors nationwide will adopt the Roth 401(k) in the next five years. And younger employees - those who weren't indoctrinated in the ways of pretax retirement savings - will lead the way in choosing the Roth 401(k) as the place to invest for the future.

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