

Taking a Look at Roth 401(k)s

This Plan May Have Benefits for Many in the Health Care Field

By DOUG WHEAT, CFP

Roth IRA conversions received a lot of press coverage in 2010 because the income limitation on these conversions disappeared. The Roth 401(k) has received much less attention, but offers tax-free growth advantages similar to a Roth IRA. Indeed, even if you decided that a Roth IRA conversion was not right for you, Roth 401(k)s are worth a look.

A Roth 401(k) is a retirement savings plan that may be offered by employers in addition to a traditional 401(k) plan. Both of these plans allow employees to designate a portion of their current salary to be contributed to the plan with the intention of using it to pay for retirement expenses in the future. The essential difference between these two types of 401(k)

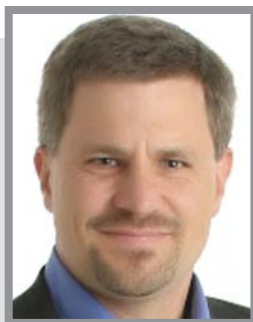
s is that, unlike a traditional 401(k) plan, contributions to a Roth 401(k) are made with after-tax dollars. However, qualified withdrawals from your Roth 401(k) are not subject to income taxes, unlike withdrawals from a traditional 401(k).

The Roth 401(k) first became available in January 2006. According to a 2011 survey by benefit consulting firm Aon Hewitt, more than 36% of mid-sized to large companies now offer a Roth 401(k) retirement plan, and this number is expected to reach 50% of employers by 2012. Nonprofit and public employers that offer a 403(b) also have the option of offering a Roth 403(b), which follows most of the same rules as a Roth 401(k). So, chances are you currently have or will soon have the opportunity to contribute to a Roth 401(k) and may want to examine whether switching your contributions from a traditional 401(k) to a Roth

401(k) is beneficial for you.

Let's look at some important features of the Roth 401(k):

- There is no income ceiling for contributors — employees at all income levels are able to make contributions.
- Contributions are made with after-tax dollars, and 'qualified distributions' may be withdrawn without tax or penalty.
- Contribution limits for 2011 are the same as a traditional 401(k) or



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403(b) — \$16,500 per year and \$5,500 additional catch-up contributions if you are over 50.

- After age 59 ½ — and at least five years after the first contributions to a plan — investment earnings can be withdrawn tax-free.
- Minimum annual distributions must begin at age 70 ½, though a Roth 401(k) can be rolled into a Roth IRA, which does not require withdrawals.
- Employer contributions or matches will be made on a pre-tax basis, the same as a traditional 401(k).

Perhaps the most crucial consideration in weighing a decision between a traditional or Roth 401(k) is your tax bracket — now and in the future. If you expect to be in the same or a higher tax bracket when you retire, a Roth 401(k) could result in greater savings. However, if you think you will be

in a lower tax bracket after you stop working, it may be preferable to contribute to a traditional 401(k). The younger you are, the more compelling the Roth 401(k) is likely to be.

Also, if you are a higher-income employee and are expecting tax rates in general to rise, you might find a Roth 401(k) attractive because you will be paying the income tax on your contributions at today's rates.

If you are uncertain about tax rates in the future, you may want to stay with a traditional 401(k). As an alternative, you might want to consider separate annual contributions to a non-deductible IRA, and then convert the non-deductible IRA to a Roth IRA. In this way, you have diversified your future tax burden by having both tax-deferred and tax-free income sources.

Let's look at some situations that apply to physicians and other health care employees.

A young resident in her 30s and just starting out in the workforce may anticipate that her future earnings will be much higher in the future and thus will be subject to higher tax rates. This person is likely to find contributing to a Roth 401(k) to be advantageous until she is in a higher tax bracket. She can fund the Roth 401(k) now with after-tax dollars and never have to worry about paying taxes on it in the future.

Meanwhile, a physician or executive in the middle of his or her career may currently be in one of the top tax brackets. In this case, contributing to a traditional 401(k) will allow him to defer taxes now when his tax rate is high and pay them in the future when his tax rate is lower.

Finally, a physician near the end of his career who will likely be in the same or higher income-tax bracket during retirement may benefit from contributing to a Roth 401(k).

Making contributions now to a Roth 401(k) using after-tax dollars will eliminate the possibility that these dollars will be subject to higher taxes in the future.

If you decide to move forward with a Roth 401(k), make sure you review how it will impact your net take-home pay. Most people select the amount they will

contribute to retirement plans based on a percentage of salary. It is important to remember that, if you currently contribute 10% of your salary to a traditional 401(k) and you switch to a Roth 401(k), your net take-home pay will decrease because you will need to start paying taxes on the amount contributed to your Roth 401(k). It

is recommended that you ask your payroll department to calculate the difference in net take-home pay from contributions to a Roth 401(k) versus a traditional 401(k). ❖

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