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Investors ponder a new 401(k) option: pay taxes now

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If you have the cash and you think your tax rate will be higher when you retire, the new Roth annuity may be for you.

By Mark Trumbull | Staff writer of The Christian Science Monitor

The latest way for employees to save for retirement demands patience, in more ways than one. First, you may have to wait for your employer to offer it. Then you'll see your money start in the slow lane compared with traditional 401(k) plans.

But the rewards of patience can be significant. Sometimes, like the children's fable showed, it pays to be the tortoise rather than the hare.

The new retirement plan is called the Roth 401(k). Like the similarly named Roth IRA, one form of individual retirement account, it does not let you put pretax income into an account.

Instead, the reward comes in the long run: Your money not only grows tax-free but also is withdrawn tax-free during retirement.

With traditional employer-promised pensions in decline, savings vehicles such as IRA and 401(k) accounts - however they are taxed - play an increasingly important role in Americans' retirement security.

The problem with Roth 401(k)s: For all their promise, they aren't yet offered by many employers.

Since Jan. 1, when employers were first allowed to launch these new plans, more companies have decided to wait and see than to roll out a Roth. One reason: fear of confusing participants with new choices.

"It does add a layer of complexity," says David Kudla, chief executive officer of Mainstay Capital Management in Grand Blanc, Mich. "At the same time, it is the right thing to do."

It's right, he says, because it lets people manage their tax burden - or hedge their tax risks. Someone who thinks that taxes will be higher in the future can focus his savings in a Roth account. Another, confident her tax rate will be lower in retirement, can stick with a traditional 401(k) that's taxed upon withdrawal. Others may try a mix of the two strategies.

"Here we're diversifying against tax risk," just as people buy both stocks and bonds to diversify investment risks, Mr. Kudla says. He predicts that many companies, large and small, will add the Roth to their 401(k) plans this year.

Mainstay, a provider of investment options for retirement plans, has already seen several large customers commit to offering Roth plans this year. General Motors, auto parts supplier Delphi Corp., and British Petroleum are among those who have announced plans to do so.

"The experience of these early adopters ... will be very telling, and will drive - to some degree - the acceptance by other plan sponsors," says Lori Lucas, director of retirement research at Hewitt Associates, a consulting firm focused on human resources.

Among the key questions: How many workers will opt in? Will others be so confused by the new choice that it delays or prevents their saving in any 401(k)? So far, there's little evidence of the latter, Ms. Lucas says. But she notes that many of the firms that now offer the Roth option are in financial lines of business. Their employees may be particularly savvy about the advantages of various styles of tax-deferred saving.

About 34 percent of large employers say they are either "very likely" or "somewhat likely" to offer a Roth 401(k) this year, according to survey Hewitt conducted in late 2005. Some remain wary because federal rules implementing the Roth plans are still being completed.

For those who do offer the plan, experts say a crucial step will be to educate employees so they can make a decision.

"They've got to decide: Do I contribute pretax [dollars] or on a Roth basis? And there's no clear answer," says Michael Weddell, a Detroit-based retirement consultant with Watson Wyatt Worldwide, another consulting firm that advises companies on benefit policies. "The details on this are just pretty overwhelming."

Adding to the head-scratching: Companies and workers can't be sure that Congress will extend the law that provides for the Roth 401(k), which currently is set to expire in 2010. That won't affect contributions already made into Roth plans, but it means the opportunity may not last.

Stripped to its essence, the choice is: Be taxed now, or be taxed later. If a worker's income is taxed at the same rate during his or her working career and retirement, the choice between a Roth and a traditional plan is financially neutral.

In the Roth case, the initial contributions can be assumed to be a bit lower, since a worker will have to spend some of the money to pay the tax on the income contributed. In a traditional plan, a worker has to be able to put more money into the regular 401(k), but it will face taxes when he or she retires. A calculating tool is available at www.fincalc.com (among other retirement calculators), which can help people compare options under different tax scenarios.

For anyone, the choice involves some guesswork about future tax rates. It may involve other factors as well. People who don't have much room in their budgets for savings may want to go the traditional route in order to maximize their tax-deferred savings. Others may go for the Roth as a kind of insurance policy, opting for the known (the current tax rate) rather than banking on an unknown (their future tax rate). In an era of concern about rising government spending, which may eventually require higher taxes, that argument may be enough to make the sale.

"That, frankly, is the reason I chose to go into a Roth myself," says Steve Blakely, who works at the Employee Benefit Research Institute in Washington. He reckons that in the future, "the tax structure will be very, very different from where it is today."

How to choose the right plan for you

For people who have a choice to make, the decision involves some simple issues and some complex ones. The simple issues include contribution limits: Anyone can contribute up to $15,000 this year to a Roth 401(k), just as they can to a traditional 401(k). (Unlike the Roth IRA, there's no income test to determine whether people qualify to contribute up to the full amount if they choose.) And as with traditional plans, the provision for $5,000 "catchup" contributions to a Roth plan is available for those over 50. An employee's Roth and non-Roth balances would be combined in tallying the amount that the worker can withdraw as a loan. Finally, choosing a Roth in one year doesn't mean employees can't opt for a traditional plan later on, or vice versa.

Ready for the more complex issues? Analysts offer these tips regarding who might choose a Roth versus a traditional 401(k):

Who benefits from a Roth

• **Young workers** whose incomes, and taxes, are likely to rise over time.

• **People with high salaries** who can afford to pay taxes up front and are concerned that high tax rates will follow them into retirement.

• **Risk hedgers** who like the idea of having a little money in both types of plan. That way, no matter which way tax rates move, they'll have some cushion. If employers offer matching contributions, those will be on a pretax basis, so opting for a Roth account is often a choice for a mix of tax treatments. This will allow the worker, once he or she retires, to decide whether to withdraw money first from the Roth or the traditional 401(k).

• **Those who want the option** of rolling their balance into a Roth IRA upon retirement. This could be useful for people who want to avoid required withdrawals upon reaching age 70-1/2.

Who benefits from a traditional 401(k) plan

• **People with little money to save**. They may make the most of their savings by deferring taxes rather than paying up front.

• **People near retirement**, who are more certain of the tax rate they'll face or who don't have time to keep their money in the Roth for at least five years - a Roth requirement - before withdrawing money.

• **People in plans where only** traditional contributions enjoy an employer matching contribution. Some employers match the non-Roth contributions but not the Roth. Find out. If you don't, you may lose out on matching funds by opting for the Roth.

• **People retiring before age 59-1/2**. Before that age, money withdrawn from a 401(k) faces taxes and penalties.
