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New Roth investment options



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Starting in 2006 the law will allow employers to offer a new option in 401(k) plans to contribute after-tax money that will go tax-free. Currently your 401(k) contributions are pre-tax, meaning you get a deduction the year you make the contribution and you pay income taxes on the contributions plus earnings when you retire.

The new option is called the Roth 401(k). It's not a separate plan from your existing 401(k) but rather a new part. You'll be asked first how much of your gross income you'd like to contribute to your retirement plan, say 15 percent. Of that 15 percent, you'll indicate how much you'd like to put in a pre-tax portion of the plan and the after-tax portion, say 7.5 percent in each.

The new part is similar to a Roth IRA, which also lets savers invest after-tax money that grows tax free, but it differs in significant ways. First, there's no income limitation as there is with Roth IRAs. With Roth 401(k)s planned participants at all income levels are eligible to make contributions.

Secondly, contribution limits differ: In 2006, you'll be able to put \$4,000 into a Roth IRA plus a catch-up contribution of \$1,000 if you're at least 50. But in your 401(k), you may contribute up to \$15,000 plus \$5,000 catch-up. Both your pre-tax and Roth after-tax contributions would be counted toward that.

And the withdrawal rules differ also: With the Roth IRA you may take your earnings out tax-free and penalty-free after five years if you use them for the purchase of your first home. You may take them out penalty-free for qualified educational expenses as well.

In a Roth 401(k) you can't withdraw earnings tax-free or penalty-free until you're 59 ½ and have had the money invested for at least five years.

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The advantage of a Roth 401(k) is that when you retire, all the money in that part of your 401(k) will be yours in full. By contrast, any money in the pre-tax part of your account will be subject to income tax.

That's why a Roth-style investment makes the most sense if you're in a lower tax bracket today than you expect to be when you retire, which is especially true for younger people. You pay less tax on your contributions now than you would pay tax on it in retirement, plus your earnings grow tax-free.

Things to think about: if your employer won't match your Roth 401(k) contributions the same way they do your regular 401(k) contributions, make sure you can contribute enough pre-tax to qualify for the full match. Secondly, it's much easier to accumulate more pre-tax 401(k) than a Roth-style 401(k), and that can even out the amount you pocket in retirement between your before-tax and after tax withdrawals. Say you decide to contribute \$10,000 of your gross retirement savings and you'll split it between the pre-tax and after tax portions of your 401(k). A full \$5,000 is invested in the pre-tax side but you may only be able to invest \$3,500 in the after tax side since that's the equivalent of \$5,000 before tax.

It is important for employees to save, 401(k) contributions reduce your taxable income dollar for dollar, but Roth IRA contributions don't. So you may see less in your paycheck and you could also lose out on some key tax breaks.

While it's impossible to know everything, we can learn something new every day. With "The Information Age," upon us, television, print media and the Internet combine to bombard us on a daily basis with reports, updates, theories, etc. on investing. The challenge of maintaining a solid base of investment knowledge is a daunting one. So if you don't know how to figure out the best way for your 401(k) plans in 2006, call your tax adviser.

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