How to use the new Roth 401(k) next year

BY AL MATHEWS

Since its birth a quarter of a century ago, the 401(k) plan has become the most popular type of employer sponsored retirement plan. It allows employees to save for their own retirement by supplementing employer contributions with pre-tax salary deferral contributions of their own. In 1998, Roth IRAs were introduced and have enabled millions of Americans to build up retirement nest eggs that they can tap into tax-free.

Created by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Roth 401(k) account becomes available to 401(k) plan sponsors and plan participants beginning in plan years starting on or after January 1, 2006. Traditional 401(k) plans may then be amended to include Roth 401(k) accounts or a separate Roth 401(k) plan can be established.

The new Roth 401(k) account blends features of the Roth IRA and the traditional 401(k) plan. As with a Roth IRA, when plan participants make after-tax contributions to a Roth 401(k) account, the money accumulates tax-free. Generally, beginning at age 59 ½ all withdrawals will be entirely tax-free. This differs from traditional 401(k) accounts where contributions are made with pre-tax dollars but withdrawals are taxed as ordinary income when plan participants take their money at retirement.

MATHEWS: Guest writer describes the differences

In a 401(k) plan with Roth accounts, employees will be able to designate what portion of their elective salary deferrals will be made as Roth 401(k) contributions. Because Roth 401(k) contributions are treated as elective deferrals, they are subject to the $15,000 maximum deferral limit in 2006 ($20,000 if a participant is eligible to make age 50 catch-up contributions). Furthermore, if a participant makes both Roth 401(k) contributions and pre-tax elective deferral contributions, the two contributions combined may not exceed the $15,000/$20,000 limits.

In order to be treated as a tax-free distribution, a distribution from a Roth 401(k) account must be a "qualified distribution". To be considered a "qualified distribution", the distribution must be made after (1) a participant reaching age 59 ½ , a participant's death, or a participant becoming disabled and (2) may not be made within five years of the first Roth 401(k) contribution to the plan or a previous Roth 401(k) plan.

From the Executive's Desk

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GUEST COMMENTARY

Why should plan participants be interested in contributing to a Roth 401(k) account?

Generally, investing in a Roth 401(k) account is preferable if your income tax rate will remain the same or be higher at retirement. In addition, the Roth 401(k) account should appeal to anyone who senses that all tax rates will increase as baby boomers retire and entitlements become a larger portion of the federal budget, and to those who are more comfortable knowing the net worth of their retirement savings.

It is anticipated that highly compensated plan participants, currently restricted from investing in a Roth IRA, will be especially eager to investigate the Roth 401(k) account alternative. Lower compensated employees already familiar with the advantages of Roth-style retirement savings are expected to be interested as well, and they can contribute to both a Roth IRA and a Roth 401(k) plan.

Early indications suggest that current 401(k) plan sponsors are interested in adding the Roth 401(k) account option. According to a recent survey conducted by Hewitt Associates, about one in three 401(k) plan sponsors are considering the addition of a Roth 401(k) account when permissible on January 1, 2006.

The time for 401(k) plan sponsors to prepare for the new Roth 401(k) accounts is now. Plan sponsors should begin to discuss with their advisors the implications of a Roth 401(k) account program for their plan and participants.