

Roth 401(k) Versus Traditional 401(k)—Which One to Choose?

Many of the benefits of a Roth IRA are now available to high income earners through the introduction of a Roth 401(k) provision. While married executives earning over \$160,000 are not eligible to open a Roth IRA, there is no such income limitation on a Roth 401(k). Executives are now faced with a new decision: should you switch some or all of your 401(k) contributions to the new Roth 401(k) or would it be better to keep contributing to the traditional 401(k)? The advantages of the Roth 401(k) should be seriously considered by most executives.

The Bottom Line: Unless you believe your income tax bracket is going to drop in the future then switch your contributions to the new Roth 401(k) plan. If you make the switch don't forget to adjust your income tax withholding because contributions to a Roth 401(k) are not deductible.

Essential Differences Between the Traditional and Roth 401(k)'s

The contribution rules are the same for both 401(k) plans, \$15,000 annually for employees under 50 and \$20,000 for those 50 and older. Similarly, the ability to borrow from the Roth 401(k) is subject to the same restrictions as the traditional 401(k). There are, however, three essential differences between the traditional 401(k) and the Roth 401(k). Two are income tax related and one impacts estate tax planning.

A traditional 401(k) uses pre-tax contributions which reduce current income tax; whereas, the Roth 401(k) requires you to make after-tax contributions. Most people are willing to do that because the retirement distributions are free from income tax. If you think your retirement income tax bracket will be lower then the traditional 401(k) pre-tax contribution may be better for you. However, during retirement, many executives do not experience a drop in marginal income tax rates. There is also the risk that tax rates will rise to pay for the economic burden of aging baby boomers. If you believe that your income tax bracket will stay the same as it is today, then the new Roth IRA may be better for you.

Both traditional and Roth 401(k)'s require minimum distributions when you reach 70½. If you intend to roll your 401(k) into an IRA; though, that may not be the case. Funds from a traditional 401(k) rolled over into a regular IRA will be subject to minimum distributions at 70½. A rollover from a Roth 401(k) to a Roth IRA, however, will eliminate all mandatory distributions.

The Roth 401(k) can provide executives an important estate planning benefit as well. Inherited assets in a traditional 401(k) or a regular IRA are first subject to estate tax, and then any distribution your heirs take is subject to income tax. In this instance the overall effective rate can be in excess of 65%. On the other hand assets in a Roth 401(k) or Roth IRA are only subject to estate tax. Distributions are income tax free.

Consequences of Electing to Contribute to the Roth 401(k)

By electing to contribute to the Roth 401(k) on an after-tax basis you are essentially prepaying the tax so that future distributions can be made tax free. Consequently your net take home pay will be reduced by the additional tax required. You should therefore determine if you need to increase your income tax withholding immediately (file form W-4 with your employer).

You should also be aware that while your Roth contributions will be tax free on distributions, the company match continues to be made into your traditional 401(k) account, and it will be taxable upon distribution just like your current 401(k) balances.

There are penalties associated with a Roth 401(k). If you take a distribution from it within the first 5 years, no matter what your age, there will be a penalty. If you are over 59½, consider taking distributions from your traditional 401(k) to avoid these penalties.

The ability to make Roth contributions is set to expire in 2010 unless Congress extends them, so your window of opportunity may be short.

If you would like additional information or have questions feel free to contact your Relationship Manager at Vantage.

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