Practical Guidance For Including A Roth 401 (K) In Your Retirement Investment Portfolio

Neal R. VanZante, University of Texas Pan American, USA
George R. Wagman, Texas A&M University-Kingsville, USA
Ralph B. Fritzsch, Midwestern State University, USA

ABSTRACT

This paper discusses details of the Roth 401 (k) and provides practical guidance for making the appropriate decisions about including this relatively new investment opportunity in your retirement portfolio.

Keywords: Roth 401 (k), Roth 403 (b), retirement portfolio, retirement planning

INTRODUCTION

In the December 2005 edition of the *Journal of Business and Economics Research*, the authors provided "tips for maximizing the value of your retirement investment portfolio." Part of the discussion in that paper involved the appropriate use of a Roth IRA in meeting retirement income goals. Since that time, as part of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), Roth 401 (k) plans became available beginning in January, 2006. In addition, the Pension Protection Act (PPA) of 2006 improved and made permanent most of the retirement provisions of the EGTRRA, thus reducing much of the uncertainty involved with offering long-term investment advice.

The purpose of this paper is to discuss provisions of a Roth 401 (k) plan and to provide practical guidance regarding the appropriate inclusion of such a plan as part of an individual's retirement portfolio. The discussions in this paper apply equally to Roth 403 (b) plans. Because many aspects of 401 (k) plans are similar to IRAs, the paper begins with a brief discussion of traditional and Roth IRAs. Then, provisions of traditional 401 (k) plans and Roth 401 (k) plans are explored.

TRADITIONAL AND ROTH IRA PROVISIONS

The Taxpayer Relief Act of 1997 greatly increased the opportunity for individuals to invest in individual retirement accounts by adding a new category of nondeductible Individual Retirement Account (IRA). While traditional IRAs had allowed for tax-deferred earnings, the Roth IRA (named after Senator William Roth of Delaware) provided for tax-free earnings. Since that time, numerous articles have compared the deductible (tax-deferred) IRA with the non-deductible (tax-free) Roth IRA.

A traditional deductible IRA allows individuals to reduce their taxable income in the year they contribute to their IRA. For example, an individual in a 25% tax bracket who contributed $1,000 to an IRA would save $250 in taxes for that year, meaning that the net contribution would only be $750. An individual who contributed $1,000 to a Roth IRA would receive no reduction in their taxable income, meaning that the net contribution would be the full $1,000. But, funds withdrawn from the deductible IRA are fully taxable while all funds withdrawn from a Roth IRA are not.

As mentioned above, numerous articles have compared the financial aspects of these choices. There is general agreement in these writings that, for those individuals who have a choice between the two types of IRAs, the major factor is the individual's income tax rate before and after retirement. Specifically, if the tax rates are the same, then it makes no real difference. If tax rates are expected to be lower in retirement, then the deductible IRA is more valuable; if tax rates are expected to be higher in retirement, the Roth IRA is more valuable.

Some authors have oversimplified the calculations to the point of ignoring some important financial aspects of differences between traditional and Roth IRAs. These factors are discussed later in this paper, but suffice it to say for now that because of numerous other advantages offered by the Roth IRA, most investment advisors now agree that the Roth IRA is the clear choice except where tax rates are expected to be much lower than during the time that individuals are making contributions to their IRA.

ADVANTAGES OFFERED BY ROTH PROVISIONS

Participation in both the traditional IRA and the Roth IRA are subject to income limitations. While the income limitations for the Roth IRA are substantially higher than those for the traditional IRA, participation in a Roth 401 (k) plan is not subject to income limitation. For that reason, a large number of high-income earners now are able to reap the benefits associated with the Roth's tax-free earnings provisions. In addition to tax-free retirement income, the Roth IRA and Roth 401 (k) plans offer significant other advantages.

For IRAs, the traditional IRA requires that funds be distributed to retirees after they turn 70 ½. Both the traditional and Roth 401 (k) plans also are subject to these required minimum distributions (RMDs). These RMDs often result in taxable income and may place individuals in higher tax brackets than they expected. They certainly result in individuals having much less control over the timing of the distributions and resulting taxes, including the taxability of social security benefits for some individuals. Provisions of the PPA allow for Roth 401 (k) plans to be easily rolled over to Roth IRAs, thus eliminating these RMDs.

Distributions from Roth plans represent contributions first, then earnings. Thus, no income tax or penalty is applied to premature distributions until all contributions have been withdrawn. A preliminary distribution from a traditional plan normally is subject to an additional 10% penalty.

Because Roth distributions are not required until a taxpayer's death, wise estate planning may extend the tax-free earnings for many years, by passing along the IRA to a grandchild, for example. In short, the Roth provisions make the Roth 401 (k) plan and the Roth IRA very effective estate planning tools.

For many middle-income and lower-income retirees, another factor favoring Roth is the taxation of social security benefits. In a recent article, two of the authors provided examples of how Social Security recipients may be subject to extremely high marginal tax rates because they must add 50% (or 85%) of their Social Security benefits to their adjusted gross income (VanZante & Fritzsch, 2003). In that article, several suggestions were offered about how to reduce or avoid the tax on social security benefits. In respect to taxation of social security benefits, the tax-free earnings offered by Roth accounts provide a clear advantage over traditional IRAs and 401 (k) plans.

Although this reduction of income taxes on social security benefits does not apply to individuals with higher amounts of retirement income, the use of a Roth account could provide a small benefit to some taxpayers by reducing their Medicare Part B premiums which are now based on income levels. This is a relatively minor point, but for those whose adjusted gross incomes fall in the appropriate range ($80,000 to $200,000 for singles and $160,000 to $400,000), the inclusion of tax-free income could make a small difference in their monthly Medicare B premiums.

401 (K) PLAN OPTIONS

Until January 2006, the only 401 (k) plans available were those that allow for tax-deferred earnings. In essence, these plans are much like a deductible IRA. Now, many employers offer their employees the option of

participating in a traditional tax-deferred 401 (k) plan or in a tax-free Roth 401 (k) plan. As is the case with the IRAs, contributions to traditional 401 (k) plans are pre-tax while contributions to Roth 401 (k) plans are after-tax.

As mentioned earlier, participation is available without regard to income limitations. For 2008, employees over age 50 may contribute up to $20,500 to 401 (k) plans. They may split their contributions between the two types of plans if they wish. The remainder of this paper deals with practical guidance for helping individuals make the right choices.

PRACTICAL GUIDANCE

Similar to the decision involving contributing to a traditional IRA or a Roth IRA, the major financial factor involves expectations of income tax rates during the working years and during retirement. If the income tax rate during retirement is expected to be much lower than during the working years (meaning low enough to offset the other advantages mentioned in this paper), then the traditional 401 (k) is likely the better choice. Otherwise, the Roth 401 (k) will prove more beneficial. Because of the uncertainty involving future tax rates, especially in light of recent major federal deficits, most financial advisors expect future tax rates to be higher, not lower.

As is the case with a Roth IRA versus a traditional IRA, individuals who are able to invest maximum amounts should choose the Roth option because they will be able to reap a higher benefit. As alluded to earlier, this is one of the factors that many authors have failed to recognize when comparing traditional and Roth IRAs. As an example, assume that a 50-year old individual in the 25% tax bracket wished to invest the maximum amount, $20,500 to a 401 (k) in 2008. Assuming a 10% earnings rate, if this amount is invested in a traditional IRA, it will grow to $53,171. If the funds were withdrawn, and the individual was still in a 25% tax bracket, the after-tax available amount would be $39,878. If the individual had placed $20,500 in a Roth 401 (k), the entire $53,171 would be available. Of course, if the individual chose the Roth alternative, the taxes paid during the year of contribution would have been $5,125 (25% of $20,500). In essence the additional $13,293 ($53,171 less $39,878) represents an <u>additional</u> $5,125 tax-free investment. So, for individuals who have the wherewithal to invest additional funds, the Roth 401 (k) is a clear choice.

In most cases, individuals will do well to choose one option or the other. However, some individuals might find it advantageous to contribute to both kinds of 401 (k) plans during the year. For example, assume that a single individual believes their adjusted gross income will be $105,000 for 2008 before considering 401 (k) contributions. Assume further that the individual wishes to maximize the benefit of their 401 (k) and IRA contributions. Finally, assume that the individual has determined that he wants to place the maximum amount possible in Roth accounts.

Because the income limit for Roth IRA contributions is $101,000 for single individuals for 2008, at which time the amount that can be contributed to the Roth IRA begins to phase out, the above individual should contribute $4,000 to a traditional 401 (k) plan and another $16,500 ($20,500 less $4,000) to a Roth 401 (k) plan. The $4,000 contribution to the traditional 401 (k) will reduce his adjusted gross income to $101,000 and allow him to contribute a full $6,000 to his Roth IRA. If the individual contributes the full $20,500 to a Roth 401 (k) plan, then the contribution to the Roth IRA will be limited to $4,400 due to the "phase out" rules. Thus, by splitting the 401 (k) contributions, this individual will be able to invest an additional $1,600 to his retirement accounts.

ADVICE FOR INDIVIDUALS WITH LOW INCOMES

As mentioned earlier in this paper, the Roth 401 (k) offers higher income employees the opportunity to participate in tax-free retirement plans. However, the Roth 401 (k) can also benefit individuals with lower income levels. This is especially true for individuals who can qualify for the "credit for qualified retirement savings contributions."

As an example, assume that married couple had an adjusted gross income (before considering contributions to retirement plans) of $27,500 for the 2007 calendar year. Assume further that the couple takes the standard deduction. For 2007, their federal tax liability would be $1,003. Because the married couple's adjusted gross

income is less than $30,000, the couple is entitled to a tax credit of $1,000 if they contribute $2,000 to qualified retirement plans. If the couple contributes $2,000 (or more) to a Roth IRA by April 15, 2008 or if they had already contributed $2,000 (or more) to a Roth 401 (k) plan, there tax liability would be reduced to $3. Thus, for a net investment of $1,000 (the $2,000 investment less the $1,000 tax credit), the couple is able to create a $2,000 tax free retirement investment.

If, in the preceding case, the couple's adjusted gross income had been $32,000 (before considering contributions to retirement plans), the best strategy would be to contribute the $2,000 to a traditional IRA or to have contributed the $2,000 to a regular 401 (k) because the $2,000 contribution would have reduced their adjusted gross income to $30,000, and they would still be entitled to the full $1,000 tax credit.

CONCLUDING REMARKS

The correct decision regarding appropriate investment plans for retirement fund contributions depends upon specific circumstances for each individual shaped by each individual's attitude toward each option. The brief examples provided in this paper are intended to offer ideas that readers may wish to consider and to explore further.

The Roth IRA has proven to be the IRA of choice for a large number of taxpayers. For the same reasons discussed in this paper, it is highly likely that Roth 401 (k) plans will quickly become the 401 (k) plan of choice for many more individuals.

AUTHOR INFORMATION

Dr. Neal VanZante, CPA, CMA, CFM, CFE is on the Accounting faculty at The University of Texas Pan American in Edinburg, TX. He may be reached at (956) 292-7842 or at nrvanzante@upta.edu.

Dr. Ralph Fritzsch, CPA is a Professor of Accounting and Chair of the department of Accounting in Dillard College of Business Administration at Midwestern State University in Wichita Falls, TX. He may be reached at (940) 397-4364 or at ralph.fritzsch@mwsu.edu.

Dr. George R. Wagman, Professor of Management at Texas A&M University Kingsville, TX. He may be reached at (361) 593-3942 or at g-wagman@tamuk.edu

REFERENCES

1. Economic Growth and Tax Relief Reconciliation Act of 2001. Retrieved from www.nysscpa.org/reconciliationact1.htm on February 7, 2008.
2. Pension Protection Act of 2006. Retrieved from www.irs.gov/retirement/article/0,,id=165131,00.html on February 7, 2008.
3. Tax Credit Now for Savings Made for Retirement. Retrieved from www.bankrate.com/brm/itax/tips/20030224b1.asp.
4. Taxpayer Relief Act of 1997. Retrieved from library.findlaw.com/1997/Jan/1/126242.html on February 7, 2008.
5. VanZante, Neal R. and Fritzsch, Ralph B. Dodging the Bullet. *Today's CPA* (July/August, 2003), 32-35.
6. VanZante, Neal R., Wagman, George R. and Fritzsch, Ralph B. Tips for Maximizing the Value of Your Retirement Investment Portfolio. *Journal of Business and Economics Research* (Volume 3, Number 12; December 2005), 35-39.