

Advisor White Paper: The Roth 401(k) vs. the Traditional 401(k)

By James Lange, Esquire, CPA

Roth or No Roth: That Is the Question Optimizing IRA, Roth 401(k) and Roth IRA Conversions

I. Introduction

The Purpose of This White Paper

Your clients could be leaving thousands, perhaps millions of dollars on the table without the optimal use of the Roth IRA, the Roth 401(k) and Roth IRA conversions. As we've proven in other articles, (please see http://www.rothira-advisor.com/roth_summary.htm) the enormous benefits of Roth IRA contributions and Roth IRA conversions can dramatically leverage your client's retirement assets. In this white paper we concentrate on the Roth 401(k). Thanks to the law establishing the Roth 401(k), financial advisors now have an opportunity to help clients initiate or expand their clients' tax-free retirement investments. An advisor can provide even greater value to their client if they help the client with a sound Roth IRA, Roth 401(k) and Roth IRA conversion strategy. For a discussion of the more basic Roth concepts, I would suggest you read this article. We also address a problem with prior analysis where we tended to use static tax bracket assumptions, assuming a fixed income tax rate for all our analysis. In this white paper we examine the Roth 401(k) using varying tax bracket assumptions reflecting the likely possibility your client's tax rate will change over time.

The Numbers Speak: The Art and Science of Roth Strategies

It is both an art and a science to help clients get the most out of their IRA and Roth IRA strategy. This white paper concentrates on the science and delves into the important numbers behind the decision. This analysis reviews the circumstances that you need to know to optimize contributions to a Roth 401(k) or Roth IRA conversion by examining new assumptions regarding tax rates and holding periods for IRA and 401(k) accounts, taking into consideration the dynamic nature of our client's lives.

Like all financial decisions, Roth IRA, Roth 401(k) and Roth IRA conversion decisions should consider lifestyle and personal preference, but for this paper we concentrate primarily on "the numbers." Based on an extensive review of alternative scenarios, we've attempted to quantify and simplify our findings to enable advisors to make more appropriate recommendations.

Shattering The Myths

This article will shatter myths, and certainly produce an outcry from some advisors who have taken a different course than what we recommend. My answer to these detractors: *Show Me the Numbers*. We believe this analysis and the logical conclusions that flow from the analysis will hold up to the most intense scrutiny and could potentially save individual clients and their families thousands, perhaps millions of dollars over time. By considering this paper with an open mind, you will hopefully be able to apply some of the analysis to your own fact patterns.

II. The New Roth 401(k)

Based on new legislation that took effect on January 1, 2006, American workers can now save all or only a portion of their retirement contributions in a *tax-free* Roth 401(k) or 403(b) plan. For 2008, that contribution can be as much as \$15,500, or \$20,500 if you're over 50. This new law has important implications for advisors who need to help their clients answer the important questions relating to retirement planning:

- “Should I contribute to my traditional 401(k) or the new Roth 401(k)?”
- “Should I make a Roth IRA conversion?” are addressed.

This Analysis Also Applies to the Roth 403(b) and Roth IRA Conversions

While this document uses the language of Roth 401(k) plans, the same analysis can also be applied to the Roth 403(b) that is quite similar to the Roth 401(k). The Roth 403(b) is likely to be available for employees in the public sector like universities, hospitals and other non-profits.

There is another critical point to keep in mind. The question of whether an employee should contribute \$20,500 to a traditional 401(k) or a Roth IRA is conceptually pretty close to the same employee asking themselves if they should make a \$20,500 Roth IRA conversion, assuming they are allowed to do so.

The time and amount of the appropriate Roth IRA conversion will become a greater factor to many *higher earning* taxpayers who will be able to convert their traditional IRAs to Roth IRAs in 2010. This is due to the Tax Increase Prevention and Reconciliation Act of 2005, which removes the modified adjusted gross income limits for a Roth IRA conversion beginning in 2010.

Retirement Planning Prior to 2006

Under traditional retirement plans, as detailed in my best-selling book *Retire Secure!*, employees with either a traditional 401(k) or 403(b) retirement plan have the option of contributing a portion of their salary to the employee portion of these plans. If an employer makes a contribution to the plan, there will also be an employer portion (often a match based on the employee's contribution).

Traditionally, and in the absence of the change in the new law, we generally recommended that employees contribute as much to their 401(k) or 403(b) plan as they can afford up to the legal limits. The result of this tax deferred growth, as opposed to

growth in “after tax” funds outside of a tax deferred plan, is much more wealth to you and your family over time.

There was, however, one exception to this recommendation. We recommended making non-matched retirement contributions to a Roth IRA rather than making such contributions to a tax-deductible 401(k) or 403(b) plan. The reasons I prefer Roth IRAs, are well documented in my book, *Retire Secure!*.

Essentially, analysis has proven that in the long run, *the tax-free compounded growth of a Roth IRA is more valuable than the tax deferred compounded growth offered by traditional 401(k) and 403(b) plans.* For those who can afford it, I generally recommended making **both** a Roth IRA contribution and the maximum 401(k) or 403(b) contribution. (A detailed explanation of Roth IRAs, 401(k)s and 403(b)s is included in *Retire Secure!*.)

What Are Roth 401(k) and Roth 403(b) Plans?

The Roth 401(k) and Roth 403(b) plans are hybrid retirement plans that possess the characteristics of both the 401(k) or 403(b) and the Roth IRA. They allow employees to treat part or all their own contribution amount (the amount deducted from their paychecks) as a Roth contribution, meaning it will receive the same tax treatment as that of an ordinary Roth IRA. This also means that the amount treated as a Roth will no longer result in a federal tax deduction as contributions to traditional 401(k) or 403(b) plans do. However, the growth of this part and its subsequent withdrawal is not subject to income tax expenses the way traditional plans are.

In short, if you have two plans, one a traditional 401(k) and the other a Roth 401(k) with the same amount of money in both, *the Roth 401(k) plan will be of greater value, since the income taxes imposed on withdrawals from the traditional 401(k) greatly reduce its overall value.*

There may be some limited circumstances where these Roth alternatives may not provide a substantially better return, but they are limited. Principally, the choice is similar to the decision between making a Roth IRA contribution or a *deductible* traditional IRA contribution.

The Differences between Roth IRAs, 401(k)s and 403(b)s

It is important to note, however, that Roth IRAs and Roth 401(k)s and Roth 403(b)s are not exactly the same. The big difference (and it’s an extremely important one) is that the Roth 401(k) and Roth 403(b) plans are available to a much larger group of people. Roth IRA contributions are only available to married couples filing jointly with adjusted gross incomes (“AGI”) of less than \$169,000, single individuals with an AGI less than \$116,000, and most married individuals filing separate returns with an AGI less than \$100,000. These restrictive AGI limitations do **not** apply to the new Roth 401(k) or Roth 403(b) plans, allowing higher income individuals and couples their first entry into the tax-free Roth environment.

The Benefits of Roth Plans

This increased accessibility is really big news. Roth IRAs have always appeared to be ideal savings vehicles for wealthier individuals, but up until January 1, 2006, these individuals have been precluded from utilizing Roth accounts due to the income limitations. The reason that Roth IRAs have tantalized those with incomes beyond Roth limitations is that Roth accounts are widely acknowledged as great long-term retirement and estate planning tools. The longer the funds are kept in the tax-free Roth environment, the greater the advantage Roth participants will attain for both themselves and their heirs.

Some of the advantages the Roth Plans have in comparison to traditional plans are as follows:

1. By choosing the Roth, you have put what would have been income tax savings going into the after-tax investment pool into the tax-free Roth account. You will receive greater value for the increased tax-free growth.
2. If your tax bracket in retirement stays the same as when you were working, you will be better off, if the Roth account grows. You would even be better off if it loses some value. The IRS can raise tax rates in the future, which increases the value of the Roth over the traditional plan. (Please note: we will look more closely at the effect of higher and lower tax brackets in retirement later in this article.)
3. If your tax bracket in retirement is higher than when you contributed to the plan, you will be much better off. There are numerous reasons why your tax bracket could be higher. Here are just a few examples:
 - The federal government could decide that it needed to raise tax rates to cover its increasing expenses and national debt.
 - Your spending needs increase with higher costs for medical care and other expenses in retirement, so you need to withdraw taxable traditional plan money for income after retirement.
 - You own or inherit wealth or income producing property or investments that begin to give you taxable income in retirement.
 - You owned your own company, and even though you retire, its steady growth has given you the ever increasing stream of income.
 - You own annuities or have other lucrative pension plans that begin paying you income in your retirement years.
4. There are no required minimum distributions (RMDs) from the Roth accounts while you are alive. Traditional plans have RMDs beginning at age 70½ for retirees. The Roth provides a much better potential long-term tax-advantaged savings horizon.
5. Your heirs will benefit from tax-free growth if the Roth is left in your estate. They can extend the tax-free growth by taking the small required withdrawals

over their lifetime. Whatever advantage you achieved with the Roth can be magnified by your heirs over their lifetimes.

6. The Roth provides greater value for the same number of dollars in retirement savings. This may lower federal estate and state inheritance taxes in an estate with the same after-tax spending power.
7. If you are a young first-year worker and do not have any taxable income now (possibly because of educational tax credits and lower wages in the first year), contributing to the Roth plan instead of the traditional plan will not cost you anything in taxes anyway, so it has a significant advantage over a tax-deductible traditional plan.
8. If you were previously unable to consider Roth IRAs because your income was higher than the limitation level, you are now able to consider the use of Roth accounts.
9. If you need to spend a large amount of your retirement savings all at once, using the traditional plan would increase your marginal income tax rate to a high level. Using the Roth plan has a significant advantage in these high spending situations. The marginal tax rate never goes up. Roth withdrawals are tax-free.
10. Having a pool of both traditional plan money (funded by the employer contributions and taxable upon withdrawal) and Roth plan money (funded by the employee and tax-free) to choose to spend from, can give you an opportunity to do effective tax planning in retirement. Not only can the Roth portion be used in high income years, like in #8 above, but also allows you to use the traditional plan in low income years when you are in potentially lower tax brackets. These low tax brackets may occur during years after retirement but before RMDs from the employers' contributions begin.

Some Drawbacks of the new Roth 401(k) and the Roth 403(b) Plans

As we've pointed out in the past, there are important disadvantages of the new Roth 401(k) and the Roth 403(b) plans that need to be considered:

1. The voluntary investments into the Roth 401(k) part of the plan from your paychecks are no longer tax deductible. This means you will probably get smaller paychecks if you contribute the same amount because of increased federal income tax withholding. By the time you file your tax return, you will have less cash in the bank (after-tax investments) due to the loss of tax savings.
2. The retirement investments may go down in value. If the decline becomes large enough, you would have been better off in traditional plans. In the traditional plans, you would have at least received a tax deduction on your

contributions. However, there is an exception to this disadvantage. You are required to liquidate all your Roth IRAs and upon doing so you recognize a loss. This loss can be claimed as a miscellaneous itemized deduction, subject to phase-outs, on schedule A. As always, prudent investment strategies should be used to reduce this possibility.

3. If Congress ever eliminates the income tax in favor of a sales tax or value-added tax, you will have given up your tax deduction on the traditional plan, and since the distribution will be tax-free anyway, in retrospect, the choice of a Roth plan would have been a mistake. It is unlikely that such a system would be adopted without a grandfathering of rules for plans in place to prevent such inequities.
4. Your tax bracket in retirement drops; you withdraw funds from retirement assets before sufficient tax free growth; and the taxes you save on your Roth 401(k) plan withdrawals are less than the taxes you could have saved using a traditional plan. This can often be the case if you earn an unusually high amount of money from your employer in one year that puts you in a very high tax bracket, such as from a large bonus, but do not end up with such high income after retirement. (Again, we will look more closely at the effect of lower tax brackets in retirement later.)

Employers that now offer a 401(k) plan or a 403(b) plan may choose to expand the options it gives its employees to include a Roth 401(k) or Roth 403(b) contribution. This change provides an unprecedented ability for employees to expand or, in some cases, begin their tax-free Roth investments.

For 2008, the 401(k) and 403(b) employee contribution limits will be \$15,500 per year (\$20,500 if you are 50 or older). This limit applies to the **total** employee contributions, whether they are to the traditional or to the Roth portion of the plan.

In other words, a 50-year old employee cannot make a \$20,500 contribution to the traditional portion of the 401(k) plan and a \$20,500 contribution to the Roth portion of the 401(k) plan, but rather the combined amounts cannot exceed \$20,500. With the new Roth 401(k) and Roth 403(b), employees will be able to contribute the same dollar amounts, but now the Roth portion of the contributions will be taxed like a Roth IRA.

A Case In Point

Perhaps an example will clarify:

Joe, a prudent 50 year-old employee, is a participant in his company's 401(k) plan. He has dutifully contributed the maximum allowable contribution to his 401(k) plan since he started working. Until he heard about the new Roth 401(k), his expectation was to continue contributing the maximum into his 401(k) for 2008 and beyond.

Now, Joe has a choice. He could either continue making his regular deductible 401(k) contribution (which has increased to \$20,500 for 2008), or he could elect to make a \$20,500 contribution to the new Roth 401(k), or he could split his \$20,500 contribution between the regular 401(k) portion and the Roth 401(k) portion of the plan. His decision will not have an impact on the employer's contribution - either by amount or the way the employer's contribution is taxed.

With Joe's \$20,500 contribution, however, there is a fundamental difference in the way his traditional 401(k) is taxed and the way his new Roth 401(k) is taxed. The new Roth 401(k) is basically taxed like a Roth IRA. That is, Joe will not get a tax deduction for making the contribution to the Roth 401(k), but the Roth 401(k) portion will grow income tax-free.

With the traditional 401(k), Joe would get an income tax deduction for his contribution to the 401(k). However, after Joe retires and takes a distribution from his traditional 401(k), he will have to pay income taxes on that distribution.

When Joe takes a distribution from his Roth 401(k) portion of the account, he will not have to pay income taxes, provided other technical requirements are met. These other requirements are usually easy to meet, and include such things as waiting until age 59½ before income withdrawals begin, and waiting at least 5 years from the time the account is opened. For the same reasons that I prefer a Roth IRA to a traditional IRA, I prefer a Roth 401(k) to a traditional 401(k).

Assuming Joe takes my advice and switches his new 401(k) contributions to the Roth 401(k) portion of the plan, he will have three components of his 401(k) plan at work. He will have the employer's portion of the plan which remains unchanged. He will have his own (the employee's) traditional portion of the plan, which consists of all the contributions plus the interest, dividends and appreciation on those contributions. Then, starting in 2008, he has a Roth 401(k) portion.

If Joe is married and his adjusted gross income is less than \$169,000, then he may have already been making contributions to a Roth IRA outside of his employer's retirement plan. As long as Joe is working, the Roth 401(k) will remain separate from any Roth IRA he may have outside of his employer's plan.

Due to the phase-out range of between \$159,000 and \$169,000, if his adjusted gross income was more than \$169,000, he would not be eligible to make any Roth IRA contribution. However, with the change in the law in 2006, high income earners will now be allowed their first entrée into the tax free world of the Roth, but it will be in the form of a Roth 401(k) or a Roth 403(b). The only loophole here is the aforementioned ability of higher earning taxpayers to rollover their traditional IRA into a Roth IRA beginning in 2010.

Married taxpayers with earned income and adjusted gross incomes of less than \$169,000 have been eligible to make maximum Roth IRA contributions outside of their employer's

retirement plan. The maximum contribution for 2008 is \$5,000 for employees under 50 and \$6,000 for employees 50 and older. What is much different for these employees that were able to make some contributions to the tax-free Roth IRA is that the amount of money that they will be allowed to contribute into the income tax-free world via the Roth 401(k) or 403(b) has dramatically increased.

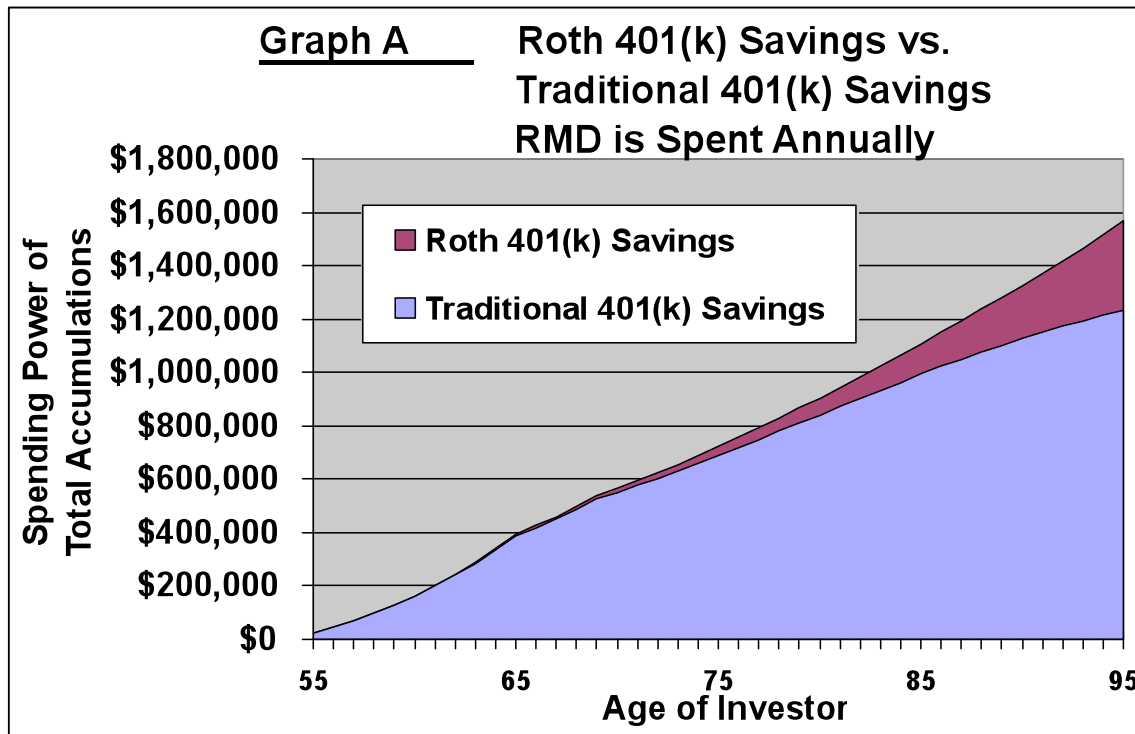
III. Quantifying the Benefit

Many clients come to me with questions on how *much* better it is to use Roth accounts versus other traditional retirement accounts. If it is a comparison between using a Roth versus not using any sort of retirement plan, or using a non-deductible traditional IRA, it is pretty easy to make the case. However, because of the nature of the advantages of the Roth as mentioned above, it is necessary to make assumptions to form an objective answer. We have made calculations and graphs showing how the Roth accounts become advantageous using the following assumptions:

1. The investor is 55 years old.
2. Annual contributions are made to either the traditional 401(k) or the Roth 401(k) for 11 years until he retires. The contributions are initially \$20,000 and increase for inflation each year thereafter.
3. By age 70, the Roth 401(k) part of the plan is rolled over to a Roth IRA to avoid additional withdrawals due to the RMD.
4. Using the traditional 401(k) plan, the tax savings on his contribution is invested in the after-tax environment.
5. Income tax rates are as follows:
 - Ordinary incremental tax rate during working years is 25%
 - Ordinary incremental tax rate during retirement years is 25%
 - Capital gain tax rates are 15% for the years through 2008 and 19% for the years thereafter (the average of 20% for less than 5-year gains and 18% for gains held over 5 years)
6. The required minimum distributions from the traditional plan are withdrawn beginning at age 70, ordinary income taxes are paid on it, and the rest is spent. The Roth account has spending withdrawals taken in the same amount.
7. Overall investment rates of return are 8% annually for all funds. For after tax fund investments, this consists of:
 - Interest income of 15% of the total return
 - Dividend income of 15% (taxed as capital gains through 2008)
 - Capital appreciation of 70%. This is not all taxed as capital gains immediately. A portfolio turnover rate of 15% per year is used to determine how much accumulated appreciation is taxed.
8. At the end of each year, we measure the spending power under each scenario. To measure the spending power of pre-tax traditional 401(k) plan balances, an allowance is made for income taxes. The tax rate of this allowance, or “liquidation rate” of tax is 25%, initially just like the ordinary tax rate.

A Look at the Numbers

Now we are able to run the numbers and graph the resulting spending power of remaining assets:



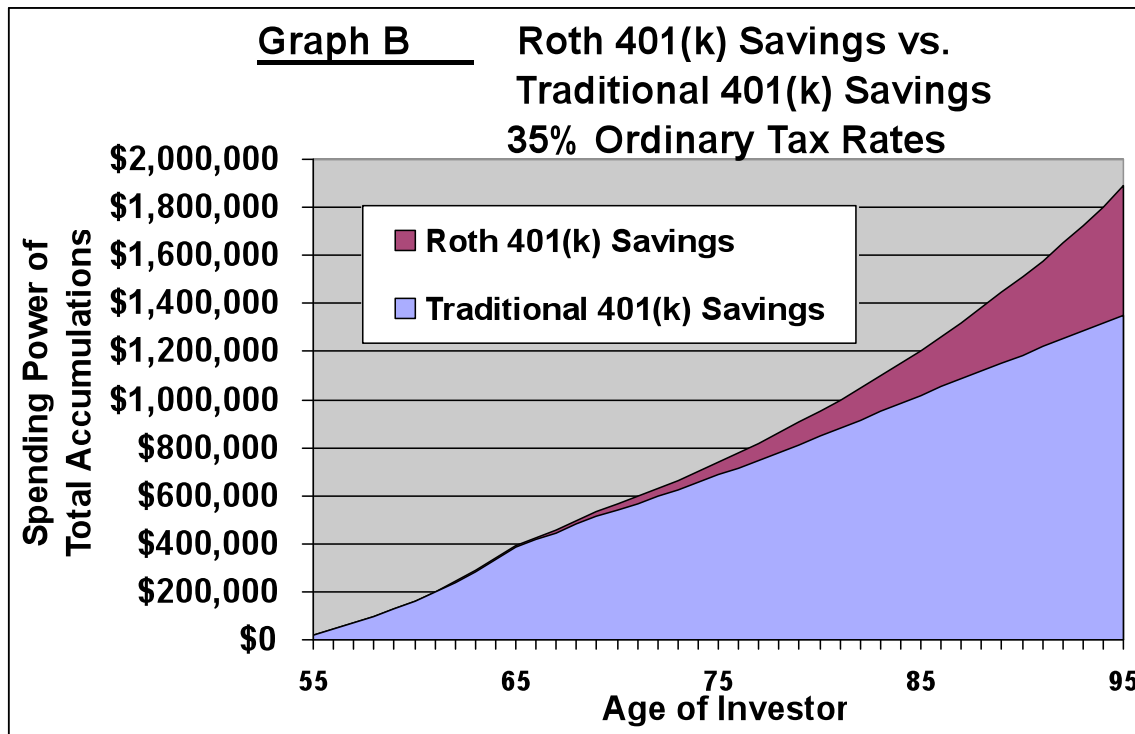
We can see from the graph that over time, there is an increasing advantage of using the Roth 401(k) instead of the traditional 401(k) plan. In fact, using these assumptions, the advantage begins in the first year. As of retirement age, the advantage has grown to \$4,869 or a 1.25% advantage. However, after RMDs begin and by age 75, the advantage is 4.68%. By age 85, it is an 11.57% advantage, and by age 95, the advantage has increased to 27.17% or \$334,966.

This advantage is significant over the 40 year projection period and should be an incentive to use the Roth 401(k) for people who find these assumptions are reasonable for them and who are able to let most of it grow for a long time. If the owner should pass away, the heir who is willing to let the money grow, can also continue the tax free growth for a long time, thus extending the advantage further.

Higher Income Taxpayers

One of the great features of these new Roth 401(k) plans is that it allows higher income taxpayers to participate in the Roth environment, where they were previously unable.

How does the advantage change in their situation? The following graph uses similar assumptions as noted above, except instead of 25%, the ordinary income tax rate is always 35%, including the liquidation tax rate used for measurement:



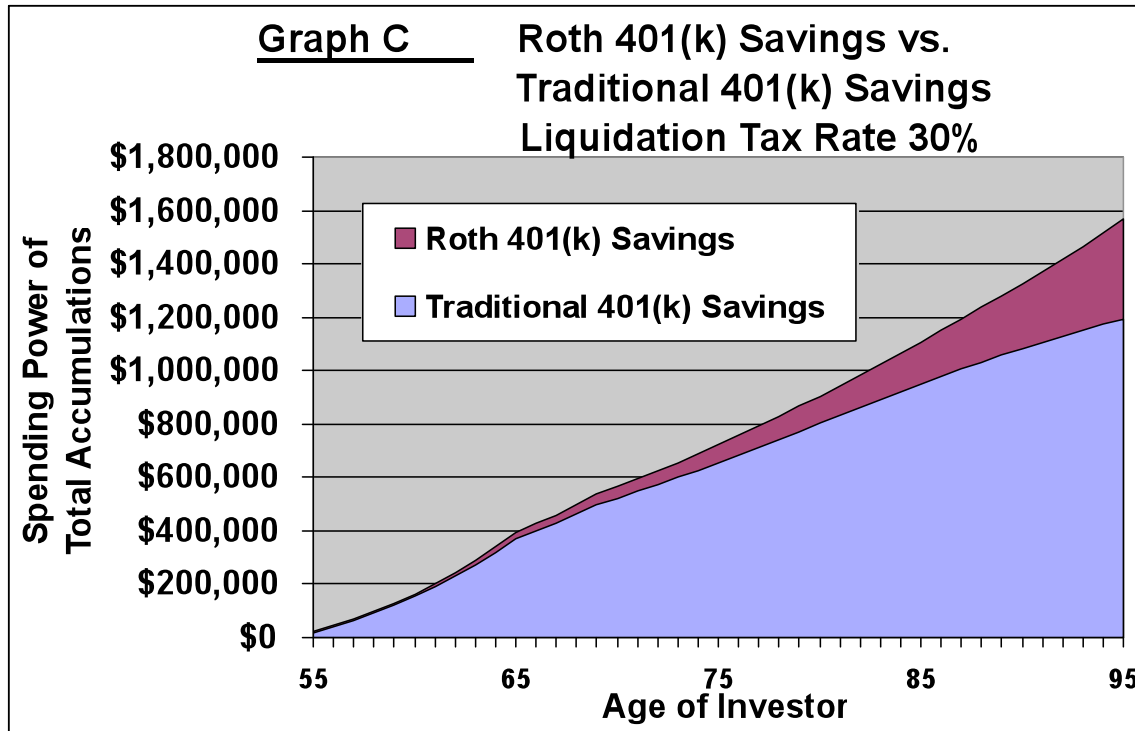
Here we discover that the Roth 401(k) has even greater advantages for a higher income taxpayer than for the lower income taxpayer in the 25% tax bracket shown in Graph A. The advantage has now become a huge 40.23% or \$541,557 after 40 years. And guess what? The higher income taxpayer is more likely not to need to spend the Roth investments, thus making the long-term gains more achievable.

The bottom line is that the Roth 401(k) is *good* for the average taxpayer but *great* for the *higher income* taxpayer.

Effect of Higher Liquidation Tax Rate

Let's further consider the "liquidation" tax rate. This is a marginal tax rate used to measure how much you could spend out of the traditional 401(k) as of each year-end. If you did need to spend the total balance, what would be your income tax rate? Wouldn't all this extra income from cashing-out the plan increase your tax bracket? What if the federal government did raise income tax rates on you in retirement?

Let's see what happens to graph A, if we use a higher liquidation tax rate of 30% for an average income level taxpayer. The graph below still reflects ordinary withdrawal rates of 25% but incorporates a liquidation withdrawal taxed at 30%.



What we find is that the graphs are similar, especially near the end of the 40 year period. After 40 years, the RMDs have reduced the traditional 401(k) balance such that the liquidation rate has a smaller comparable effect.

However, in the center of the graph, we find that the Roth has a bigger comparable advantage than in Graph A. This shows that the use of a Roth 401(k) protects our nest egg from the additional income tax costs should we unexpectedly need to spend all the funds in the middle of retirement. This might be a typical situation for a retiree that needs to liquidate a large amount of retirement funds in order to move into a retirement home.

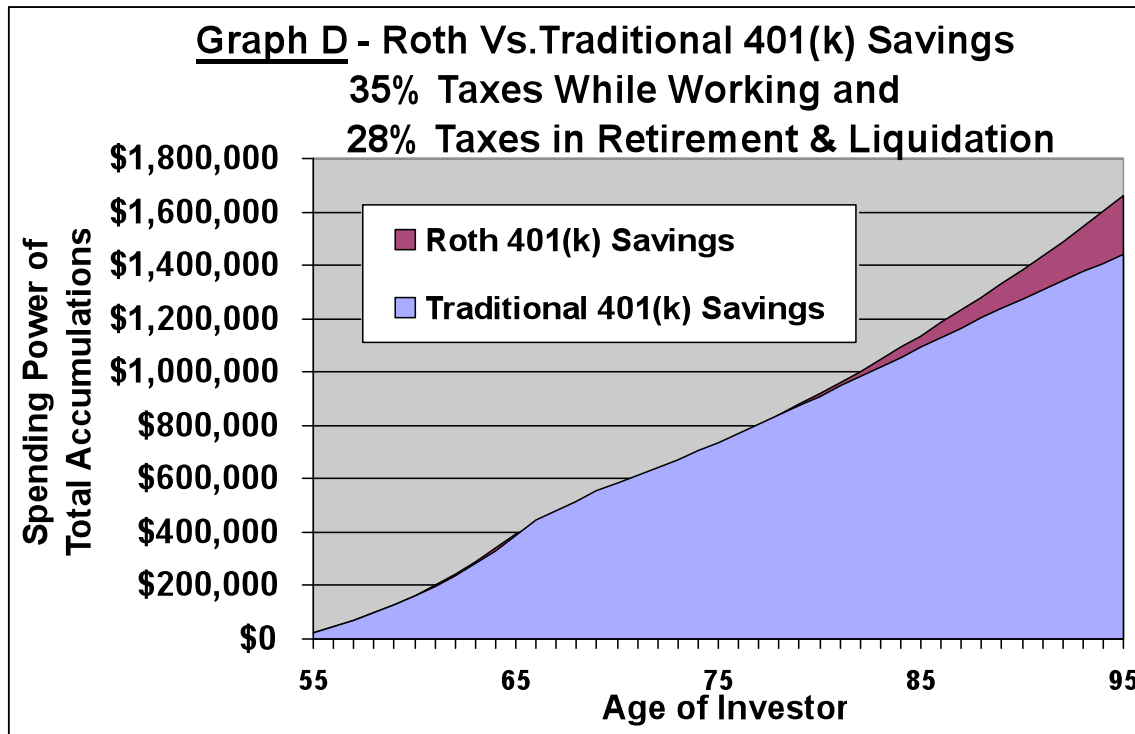
The Roth 401(k) provides a level of safety from the income tax burden if a large liquidation is necessary, for whatever reason. Whatever the financial problem is, it need not be made worse by extra-high marginal income tax brackets.

Effects of Higher Tax Rates During Working Years Than in Retirement

A common situation that makes a Roth 401(k) less appealing is when the employee earns a high income from his job, and is in a high tax bracket during working years, but when he retires, he is in a lower tax bracket for several reasons. The main reason is that paychecks were more than enough to live on. He or she has accumulated enough after-tax funds from paychecks to survive only on spending of this money, social security, and RMDs from the traditional 401(k) beginning at age 70.

If we now make a graph similar to Graph B above, but instead of continuing the 35% ordinary tax bracket throughout retirement, we use a lower 28% tax bracket, and we also

use the liquidation rate equal to the ordinary tax rate of 28% in retirement, we find the graph to look as follows:



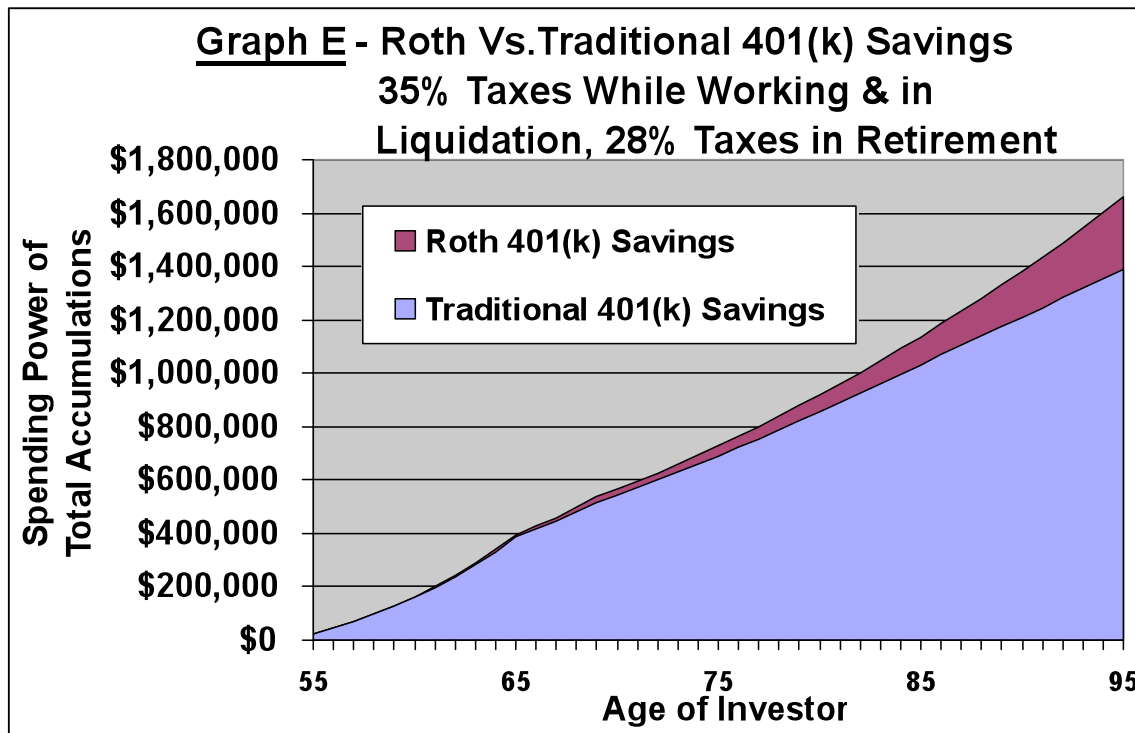
This graph illustrates that there is still a long-term advantage for the Roth 401(k), although it is an otherwise smaller advantage when the income tax rates are lower in retirement as illustrated. The numbers show the Roth has an advantage until we drop the liquidation rate from 35% at age 65 to 28% at age 66. Then the traditional 401(k) has the advantage of 4.35% or \$19,357 (hidden in this graph). This slight advantage decreases until age 79 when the Roth 401(k) again has the advantage. The advantage builds until age 95 when the advantage is 15.27% or \$220,386.

Again, when the long-term plan is to keep the money in the tax-free Roth environment for a long time, possibly leaving it to heirs who will do the same, the Roth is the preferred vehicle.

Graph D is hard for many people to believe. How can the Roth become better with lower taxes in retirement – and a full 8% lower in this example? The answer lies in the fate of the original income tax savings generated by using the traditional 401(k). This money went into the after-tax investment pool where its growth became subject to income taxes. These taxes don't seem like much – ordinary taxes on interest (and dividends after 2008), and much smaller income tax rates applied to capital gains. But these taxes, even at their reduced rates, are fiercely disadvantaged in contrast to the Roth 401(k) where growth is *entirely tax-free*.

Conditions Where Higher Liquidation Rate May be Appropriate

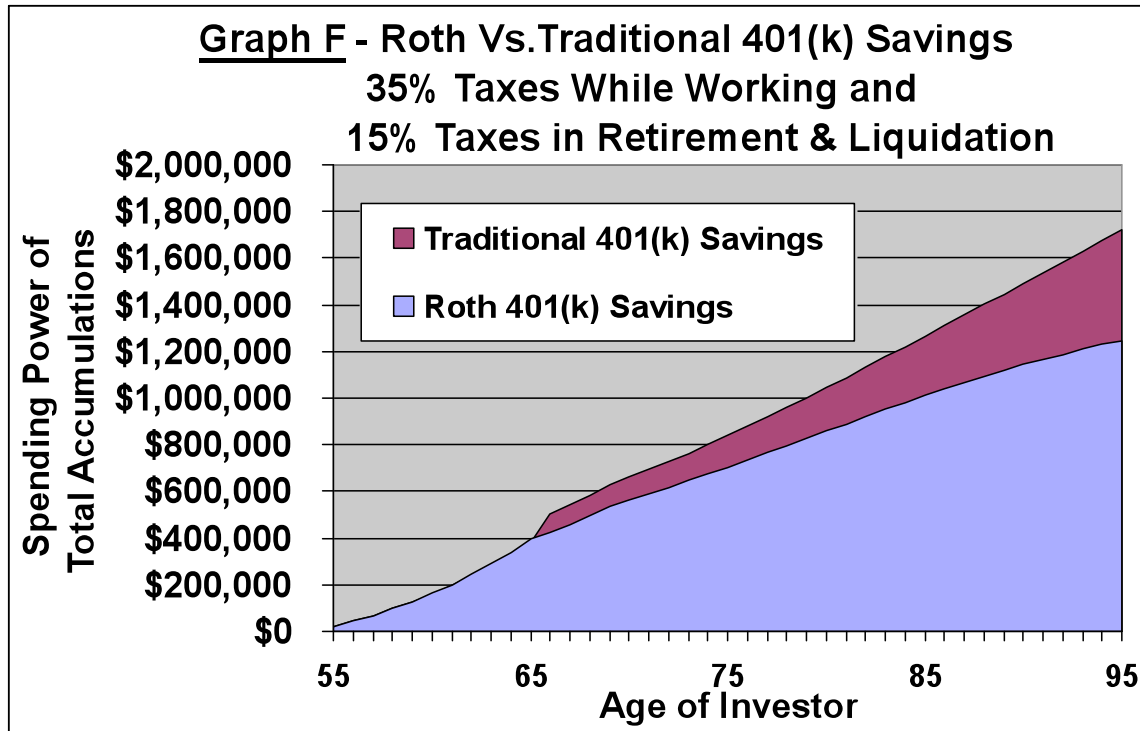
An objective analysis of Graph D would contain some skepticism in the use of a 28% liquidation rate. We should probably apply a higher marginal rate to traditional plan balances to allow for higher marginal rates if it is liquidated. Also a higher rate should be used to allow for the potential advantage the heirs would realize after death on the continuation of tax-free growth. Actually this advantage the heirs have can be much more than a few percent, if tax-free growth is maximized over their life expectancy. Super long-term calculations have illustrated that a Roth inheritance can be worth over 50% more than that of an after tax fund inheritance. Suffice to say that an heir would much rather inherit a Roth account than after-tax money. In any case, the use of a 35% liquidation tax rate on Graph D may be more appropriate. This assumption is used in the graph below:



Like in Graph C, there is not much difference after 40 years. However, during the rest of the retirement years, there is NO disadvantage to a Roth 401(k) as Graph D demonstrates. The bottom line here is that even with somewhat lower tax rates in retirement as illustrated, **the Roth 401(k) is better.**

Extremely Lower Tax Brackets in Retirement

In a sobering illustration however, we can see where the Roth 401(k) is not an advantage. The following graph assumes that an individual in the 35% tax bracket during their working years who retires in a 15% tax bracket. Maybe most of what they have is Roth IRAs and little else – for whatever reason. The graph shows a different story:

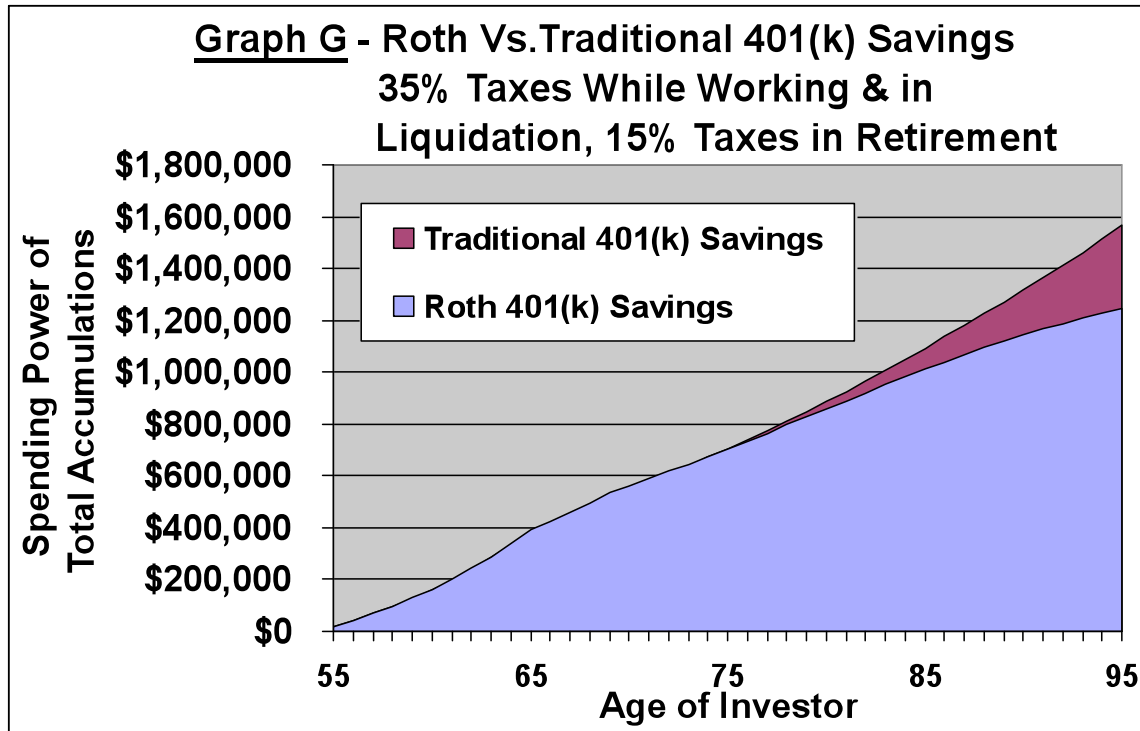


Here the Roth 401(k) contributor went too far. The Roth has its usual advantages (hidden in this graph) while all tax rates are 35%, but when we drop the liquidation and subsequent tax rates to 15% (and consequently also lower the capital gains rates), the traditional plan becomes better. By age 95, the Roth 401(k) is disadvantaged by 37.93% or \$473,430.

The bottom line here is that in order to get the tax advantages from the Roth, you should ensure that you will still have a tax rate in retirement that is not too much less than while working. Otherwise, the tax deduction from traditional 401(k) contributions is too good to pass up. Typically, the Roth is used after a decent taxable retirement income is ensured.

When Higher Liquidation Rates Should Be Considered

Even if you do accidentally fall into the 15% bracket, your heirs may not. And they will reap continued tax-free advantages from the Roth 401(k). So using the 35% liquidation rate in the Graph F above may be appropriate. Here is another graph to illustrate this:



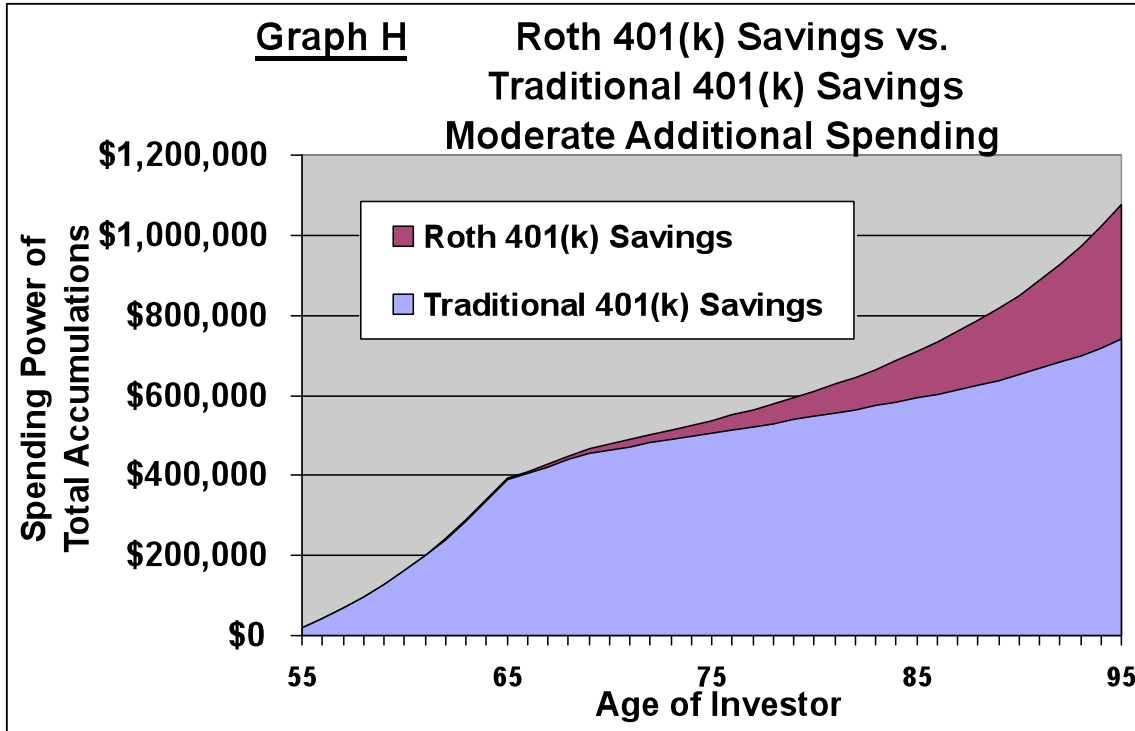
This graph and related calculations show the Roth 401(k) retains an advantage of up to 3% until age 76, when the traditional plan has the advantage due to lower taxes upon withdrawals. Again if these substantially lower income tax rates persist for long enough after retirement, the traditional plan ends up better like in Graph F.

Spending Down the Roth 401(k)

All the above graphs may indicate that the Roth 401(k) is a good idea and can eventually result in huge gains for the family. But what if you need to spend it? As a quick answer, if that is all you have to spend, without any other taxable income, like in graph F, you may be better off taking the original tax deductions on the traditional 401(k).

But what about a more balanced situation, where you have a pension income as well as social security, and your tax rate is 25% all along – like in graph A, and you need to tap into your nest egg, taking more than RMDs? Will depleting the Roth 401(k) over time make it a mistake?

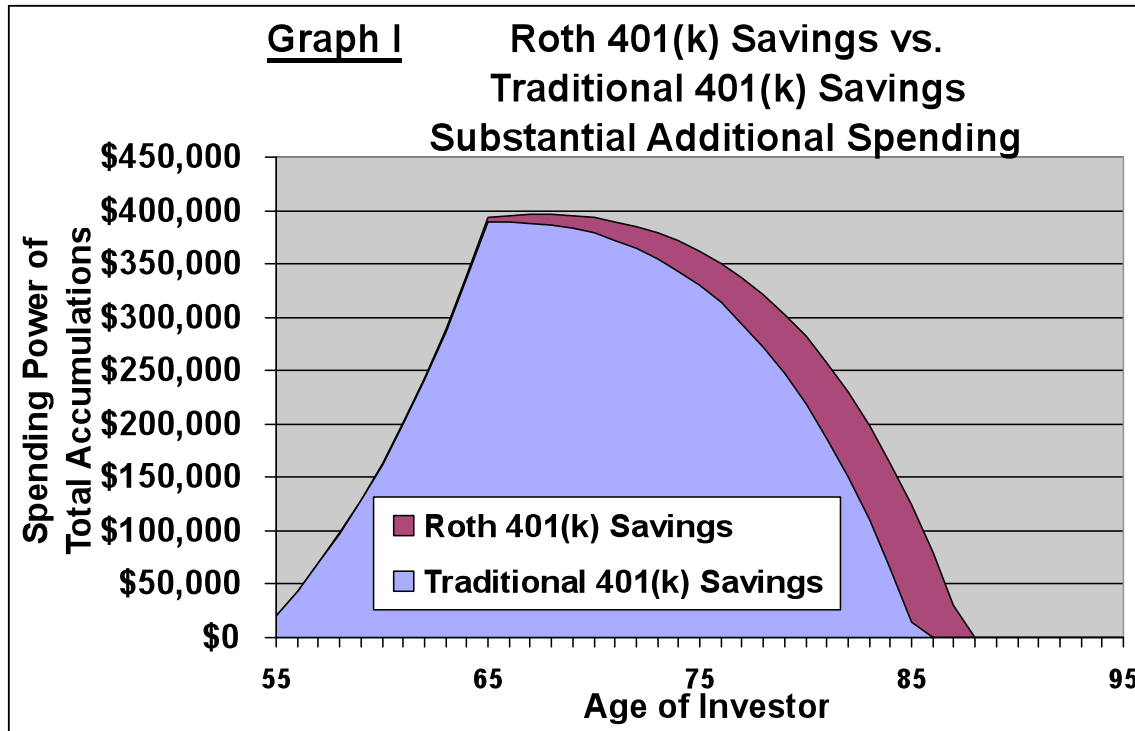
To answer this question graphically, we prepared the following graph which is similar to Graph A, but instead of taking only the RMDs from retirement accounts, we take \$20,000 from the traditional 401(k) during ages 66-69 and \$20,000 more than the resulting RMDs thereafter:



These results still show a significant advantage to the Roth 401(k) due to the tax savings from the first year. This level of spending is higher in the first years, but actually becomes lower in future years because of a much reduced RMD.

The end result of this sooner-than-expected withdrawal rate is not significant to the decision of which is better. The Roth still grows its advantage to 45.19% or \$334,966 by age 95.

Let's try again. This time we will begin to take \$40,000 at age 66 and increase the withdrawal every year for inflation. This creates a graph as follows:



Now the Roth advantage is less apparent. The traditional 401(k) plan runs out of money at age 86, but the Roth 401(k) plan runs out at age 88 – a period of slightly over 2 years. This graph does not make the Roth 401(k) look quite as favorable as some of the other graphs, but 2 years worth really is a significant advantage.

The bottom line is that despite the excessive spending in retirement, the Roth 401(k) is still better than the traditional 401(k) plan.

IV. CONCLUSION

These plans can and will change people’s lives for the better. Subject to a few exceptions discussed above, if your clients have access to a Roth 401(k) or Roth 403(b), I highly recommend you taking advantage of that option. And if they can afford it, contribute the maximum. When the time is appropriate, I like to consider Roth IRA conversions based on the analysis in this white paper.

Making It Happen

Notice, however, there is a caveat. I said “if they have access.” Though Congress has recently created these Roth 401(k)s and Roth 403(b)s, that doesn’t mean your client’s employer will adopt these plans. In the past, a retirement plan administrator only had to keep track of the employer’s portion and the employee’s portion. Now, the administrator must keep track of both of these, **plus** the employee’s Roth portion. And, there will be additional costs to update all the plan documents to provide for this new feature. There may also be changes in the way the Plan prepares its forms 1099-R for distributions from

the Plan. These and other factors may result in extra costs for some employers and may cause them to be hesitant to make the change.

If your client is an *employee* who is not given the option of a Roth 401(k) or Roth 403(b), I would gently (or not so gently depending on your personality and the office politics) suggest that the employer adopt the Roth 401(k) or Roth 403(b) plan and allow your client to participate. In the case of a *retirement plan administrator* or owner of a small business, and if your client has not already considered implementing a Roth 401(k) or Roth 403(b), I would strongly consider it. For most readers, however, the expansion or entrée into the tax-free world with Roth 401(k)s and Roth 403(b)s will be one of the best things you can do for your client.

Disclaimer: This white paper was not approved by any compliance organization. This information is intended to provide general information and is not intended as a substitute for your own research and analysis or the advice of an IRA and retirement plan expert. Transamerica did not endorse this article. I sent you this white paper because you gave me your business card when I offered this white paper.

