The New Roth 401(k) Offers Retirement Savings with a Different Tax Treatment
By Barclay Rushton

By now, you've probably heard of the ROTH IRA which allows people to set aside after-tax funds in a retirement account. Those funds grow in value and can be withdrawn at retirement with no tax consequences, provided you're at least 59 ½ and you've held the account for five years or more. The Roth IRA limit for 2005 is $4,000 or $5,000 for those 50 and above.

But did you know that beginning with the 2006 tax year your employer can provide a ROTH option in your company's 401(k) plan? Through this option you can save up to $15,000 per year but no more than 25% of your salary if you're self-employed. For people 50 years of age and older, there's a catch-up provision that allows an additional $5,000 contribution for a total of $20,000 as long as the 25% salary limit isn't exceeded for self-employed people.

The Roth 401(k) could be a boon for high-income individuals who haven't been able to contribute to a Roth IRA because of income restrictions. In the past, the $160,000 annual combined family income limit for a Roth has been an obstacle for many. With the Roth 401(k), you can contribute no matter what your annual income is.

This is a better option than a traditional 401(k) particularly if you are interested in shielding your retirement funds from income taxes and estate taxes for your heirs. Here's why. Let's say your IRA is worth $400,000 at retirement and you unexpectedly pass away. Did you know that your heirs could pay up to 85% of that money in taxes to the federal government? That could amount to $340,000. If you had invested in a ROTH IRA, there would be no income tax due on those funds which would put $160,000 more in your pocket.

Not only is the Roth 401(k) a good option for high-income people trying to increase retirement funds and stop tax erosion, it is also worthy of consideration by people in the 15% and 25% tax brackets. Individuals in these lower tax brackets can pay taxes now and won't have to worry about what their tax brackets might become in the future.

If this sounds interesting to you, talk with your tax advisor to see if it's the best route for your retirement savings. If it is, then talk with your employer. The ROTH 401(k) is not automatically added to existing 401(k) plans. Your company's plan must be amended.

For employees to take advantage of it for the 2006 tax year, employers need to amend company 401(k) plans as soon as possible, because Roth 401(k) contributions must be made through payroll deduction.

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Side bar:

The Roth 401(k)

• Effective for 2006 tax year.
• Invest after-tax funds.
• No annual income limit.
• Save up to $15,000 a year but the 25% of annual salary limit may apply.
• Additional $5,000 catch-up provision for those 50 and older.
• Must be amended to company 401(k) plan.
• Funds must be contributed through payroll deduction.
• Shields retirement funds from income taxes at retirement or upon death.