To Roth or Not to Roth?

More choice—and individual responsibility—in retirement investing means workers need to consider their options carefully.

by Delton L. Chesser, Charles E. Davis and Timothy S. Thomasson

EXECUTIVE SUMMARY

■**Companies took a wait-and-see attitude** toward the Roth 401(k) in the plan's first year, but researchers say 2007 is nearly certain to see rapid growth in participation by companies and enrollment by employees.

■**CPAs can help workers** decide between a traditional and a Roth 401(k) plan by guiding them in assessing savings habits and expectations for retirement. In general, workers who expect to be in a higher tax bracket at retirement than when they were working stand to benefit most from a Roth 401(k).

■**Traditional 401(k) plans** are funded with pretax dollars, which, along with earnings, are taxed at withdrawal. Roth 401(k) contributions are taxed, but earnings grow tax-exempt. Roth 401(k)s allow higher income and contribution limits than Roth IRAs.

■**Workers investing for retirement** also can benefit from balancing allocations between stocks and bonds, depending on their investment strategy and risk tolerance. Short-term investors need to consider the effects of taxes at ordinary income rates.

■**Depending on their ordinary tax rate,** those who tend to turn over investments in less than a year in a non-Roth account can more profitably hold stocks in pretax accounts and bonds in taxable accounts. But for those who leave their investments in place for more than a year, taking advantage of generally lower capital gains tax rates, the opposite holds true.

■**Balancing investments for volatility and risk** often is the subject of complex allocation guidelines, but many professionals say dividing funds among five classes of assets—money market, bonds, growth stocks, small-cap stocks and international stocks—can

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provide comparable returns and risk protection.

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The Roth 401(k) is here to stay, now that Congress has authorized the employee retirement savings plan past a 2010 sunset provision. In 2006, the first year it was available, relatively few companies offered a Roth. Now more employers are adding it to workers' array of strategies for retirement planning (see "Roths on the Rise"). But the Roth plan may bewilder some employees trying to rate its savings power against traditional 401(k)s and other options. Fortunately, CPAs can help sort out the myriad tax and other implications that can scare people away from even getting started socking away a reserve.

Time Out of Mind

Percentage of workers and retirees who spent at least four hours a year planning for

Holidays……74%
Social events……57%
Retirement……49%

Source: Employee Benefit Research Institute, 2003 Retirement Confidence Survey, www.ebri.org.

The phobia is real: Nearly one-third of American workers don't take advantage of opportunities for retirement savings, the Employee Benefit Research Institute found in its *2006 Retirement Confidence Survey.* And they haven't given the matter much thought, either. A 2003 survey found more than half had spent fewer than four hours a year on retirement planning. Here's how CPA personal financial advisers can help take some of the mystery out of retirement savings choices by helping clients decide between a Roth and a traditional 401(k).

To determine which is better, advise clients to consider their tax bracket now and as they expect it to be at retirement, as well as their current income and maximum annual contributions. Traditional 401(k) plans are funded with pretax dollars, which grow tax-free until withdrawn. Roth 401(k)s, whose earnings are tax-exempt, are funded with after-tax dollars.

The Roth 401(k) also differs from the earlier Roth IRA. Participation in Roth 401(k) plans is not limited by the income rules applicable to Roth IRAs, under proposed rules applicable at least until 2009. Also, maximum allowed contributions to a Roth 401(k) are higher than for a Roth IRA. In 2007 the limit for a Roth or traditional 401(k) in most cases is $15,500 ($20,500 for age 50 or older), as opposed to $4,000 for a Roth IRA ($5,000 if 50 or older).

Roths on the Rise

The Roth 401(k) plan lagged out of the starting gate but now is likely to find favor with employers and workers, analysts say.

Adoption rates for the plan were in the low single digits in most of 2006, as companies took a wait-and-see stance toward the Roth during its first year (see From The Tax Adviser, "Starting in 2006: Roth 401(k)s," *JofA*, Dec.05, page 91). The primary reason: Its long-term future hung in limbo, with authorization set to expire after 2010, according to human resource services provider Hewitt Associates.

All that changed when Congress enacted the Pension Protection Act in August 2006. The Roth 401(k) became permanent, and many more plans will begin in 2007, says Pamela Hess, senior retirement consultant at Hewitt Associates.

In 2006, about 5% of companies offered employees a Roth 401(k) option, according to a Hewitt survey. But Hess thinks those numbers "could jump up to 10%, 15%, even 20% over the next year or so." More employees will enroll if they're given clear guidelines and can model the future value of their contributions with tools such as online calculators, she says. And advisers outside the workplace can play a role. "As individuals meet with their financial planners or accountants, if they're getting guidance that these Roths are helpful, the more the better," she says.

Early data suggest that young, recently hired workers are more likely than senior colleagues to start Roth 401(k) plans. Hewitt studied data from 61,000 employees in three companies that were among the first to offer Roth 401(k) plans. Participation rates were inversely proportional to age, in line with the prevailing view that a Roth can best benefit workers who expect to be in an equal or higher tax rate when they retire and have many years ahead of them to compound a

Roth's tax-free earnings. All three companies studied were financial or professional service businesses, which likely contained more investment-savvy employees than the average enterprise, Hess noted.

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TAXES IN RETIREMENT ARE KEY

Let's take the example of a young couple, Kurt and Erica, who are both 30 and plan to retire at age 60. They recently switched from defined benefit to defined contribution plans that offer a traditional 401(k) and a Roth 401(k) savings plan as options.

Erica and Kurt have chosen to invest $6,000 each in pretax accounts, based on their combined annual earned income of $145,000. In addition,

■For both Roth and traditional plans, Kurt and Erica's employers match half of the first $3,000 in employee contributions. Matching contributions, however, can be made only to a pretax account.

■They expect to be in the 28% tax bracket until they retire.

■Their investments yield a 5% return.

Kurt and Erica's CPA can project their after-tax wealth for three investment scenarios using three possible tax rates after retirement (see exhibit 1). The scenarios show, generally, the Roth option offers higher returns to workers who expect their tax rate in retirement to remain at least as high as while they were working.

EXHIBIT 1 Projected After-Tax Wealth Based on Three Scenarios

Current income tax rate	28%	28%	28%
Retirement income tax rate	15%	28%	33%
Scenario 1: Traditional 401(k)			
Before withdrawal	$996,583	$996,583	$996,583
After withdrawal	$847,095	$717,540	$667,710
Scenario 2: Traditional/Roth 401(k)			
Before withdrawal	$884,965	$884,965	$884,965
After withdrawal	$795,273	$717,540	$687,642
Scenario 3: Roth 401(k)			
Before withdrawal	$773,348	$773,348	$773,348
After withdrawal	$743,451	$717,540	$707,574
Note: All investments yield a 5% pretax rate of return.			

Scenario 1. Kurt and Erica each contribute $6,000 (total $12,000 pretax) to traditional 401(k) plans. Each employer makes a $1,500 matching contribution (total $3,000 pretax).

Scenario 2. Kurt and Erica each contribute $3,000 (total $6,000 pretax) to traditional 401(k) plans and $3,000 in Roth 401(k) plans. Each employer makes a $1,500 matching contribution (total $3,000 pretax) to a traditional 401(k) plan. Their total after-tax Roth investment—again, at a 28% tax rate—is $4,320 [$3,000 (1 – .28) x 2].

Scenario 3. Kurt and Erica each contribute $6,000 to a Roth 401(k) plan offered by their employers. Their total after-tax investment in Roth 401(k) plans is $8,640 [$6,000 (1 – .28) x 2]. Each employer makes a $1,500 matching contribution (total $3,000) to a pretax account.

The amount of accumulated after-tax wealth available to the couple at retirement depends upon their tax rate in retirement and the tax efficiency of each scenario above. If their tax rate remains 28% after retirement, all three scenarios will provide the same accumulated after-tax wealth. But if their tax rate drops to 15% at retirement, the couple will accumulate the most after-tax wealth ($847,095) using scenario 1, the traditional 401(k) option. Conversely, if their rate at retirement increases to 33%, then scenario 3, the Roth 401(k) option, offers the greatest accumulation ($707,574).

Kurt and Erica should consult with their CPA to monitor closely any movement of income tax rates and their investments' rates of return. The important thing is for them to start a retirement plan now (see "Starting Out on the Right Foot"). Here's an

illustration of the power of compounding earnings over time: If they wait until age 40 and contribute $5,000 a year for 25 years at a 6% rate of return, they will accumulate $290,782 by age 65. But if they start at age 30, they could invest $5,000 a year for just 10 years, then contribute nothing for the remaining 25 years until age 65, and still accumulate more ($299,830) than if they had started later.

Starting Out on the Right Foot

by Randi K. Grant

For every dollar they earn, Americans spend $1.22—a negative savings rate especially pronounced among young adults. To counter that trend, the AICPA, with state CPA societies and the Ad Council, launched Feed the Pig, a campaign to encourage people age 25 to 34 to plan ahead financially. Saving for retirement hasn't been a top priority for workers: only 44% said they were on track or ahead of schedule, according to the Employee Benefit Research Institute (EBRI). It's up to you, the CPA, to point out to clients that even in their 20s or 30s, cultivating a habit of saving can build a lifetime of reserves.

Since we're all creatures of habit, it's important to establish a pattern of setting aside as much money as possible from each paycheck (see "The Best Use of Spare Cash," *JofA*, Sep.06, page 41). The first step toward nurturing a nest egg should be to clear any debt, such as credit cards with high interest rates. The EBRI's study also found six out of 10 workers considered their debt level a problem in saving for retirement.

Once your clients have paid down some—if not all—debt, they should calculate lifestyle costs and whether they'll retire early or continue working past their mid-60s. CPAs should suggest such clients also build savings for short-term needs and invest for the greatest possible return within their risk tolerance. Financial advisers also can urge these workers to take advantage of automatic contributions from their paycheck and employer matches of contributions.

—Randi Grant, CPA/PFS, CFP, is director of tax and personal financial planning at Miami-based Berkowitz Dick Pollack & Brant LLP.

A QUESTION OF BALANCE

Another choice the couple may face is balancing return and risk in their portfolio. They need to know which securities they should hold for the long term—thus making them eligible for favorable capital gains tax rates—and which for the short term. Specifically, their CPA should advise how long and in which type of account to hold stocks, with their higher gains, as opposed to lower-return but more stable bonds.

» Practical Tips

- Suggest to clients that a Roth 401(k) account can be an attractive option, especially for younger workers who expect to have many years ahead to benefit from its tax-free growth.

- Advise clients to take full advantage of any matching contributions to a 401(k) offered by employers.

- Suggest your clients increase 401(k) contributions with some or all of their pay raises.

- Suggest they diversify investments, keeping no more than 10% of their savings in any one corporation's stock, including their employer's.

Kurt and Erica are moderately aggressive investors. They split their investments evenly between stocks and bonds, and they rebalance annually to maintain a relatively constant level of risk. Two comparison portfolios show if they turn over the investments within a year—which would mean ordinary income tax rates apply—they will receive a higher rate of return by having stocks in a tax-preferred account and bonds in a taxable account (see exhibit 2). If, on the other hand, they leave the securities in place for more than a year, taking advantage of long-term capital gains rates, the opposite is true. For the purpose of this example, we'll assume stocks appreciate 6% a year and yield 2% in dividends, for a pretax return of 8%, while bonds return 5%.

EXHIBIT 2 After-Tax Rates of Return

		Short-term investment	Long-term investment
Portfolio 1	Stocks in pretax accounts	8%	8%
	Bonds in taxable accounts	3.6%	3.6%
	After-tax rates of return	**5.8%**	**5.8%**
Portfolio 2	Stocks in taxable accounts	6.22%	6.8%
	Bonds in pretax accounts	5%	5%
	After-tax rates of return	**5.61%**	**5.9%**

Except for qualified dividends, short-term investors are taxed at their normal income tax rate for all income and gains. Since stocks provide the greater rate of return in this example, they yield greater tax savings and more wealth when invested in a tax-preferred account. In contrast, long-term investors accumulate more wealth when they invest bonds in a tax-preferred account. Kurt and Erica also should periodically rebalance their investments to protect against volatility and risk. Many professionals believe dividing funds among five asset classes—money market, bonds, growth stocks, small-cap stocks and international stocks—provides a rate of return and risk protection comparable to more complex allocations (see exhibit 3).

EXHIBIT 3 Sample Portfolio Asset Mixes

	Risk Level		
	Low	**Moderate**	**Aggressive**
Money market	30%	10%	
Bonds	40%	40%	30%
Growth stocks	30%	30%	50%
Small-cap stocks		10%	10%
International		10%	10%

Source: Standard & Poor's Asset Allocation: A Sound Investment Strategy.

A WELL-EQUIPPED TOOLBOX

A Roth 401(k) gives workers another option in retirement savings plans. But to assess its benefits, CPAs must consider clients' goals and resources up to and into retirement. Increasingly, CPAs will be called on to advise clients on the wisdom of paying taxes on their retirement fund now vs. later. Alternately, CPAs can show clients the wisdom of letting long-term capital gains rates work for them, especially with aggressive-growth assets, while keeping lower-yield securities in a traditional 401(k) or other pretax account. As with a physical structure, helping clients build their financial future is easy, as long as they're given the right tools and shown how to use them. ❖

AICPA RESOURCES

AICPA PFP Center and PFS Credential

The AICPA Personal Financial Planning (PFP) Center provides a range of valuable resources that CPAs need for professional and ethical financial planning. The center also contains information about the AICPA Personal Financial Specialist (PFS) credential and PFP section membership. For more information go to http://pfp.aicpa.org.

Article

"Roth 401(k) Distributions," www.cpa2biz.com/Wealth+Management/Roth+401k+Distributions.htm.

CPExpress

2006 Quarterly Update—Tax—No. 1: Roth 401(k); Hurricane Relief; Section 409A rules; Inflation Adjustments, www.cpa2biz.com/OnlineProducts/CPExpress/Taxation/IB_HBK.htm.

Download

AICPA 401(k) Practice Guide (# 059517). Free to AICPA Tax Section members. Go to www.cpa2biz.com for more information.

Web Sites

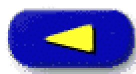
"Feed the Pig" national public service campaign from the AICPA and the Advertising Council offers savings calculators and other resources. Go to www.feedthepig.org. See also www.360financialliteracy.org.

OTHER RESOURCES

■ Investment and retirement calculators, cgi.money.cnn.com/tools.

■ National Association of Investors Corp., www.betterinvesting.org.

■ *The Right Formula for Retirement,* by Steven Goldberg, www.kiplinger.com/columns/value/archive/2004/va0217.htm.



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