Roth Treatment is 401 OK

By Reg P. Wydeven
June 25, 2005

In a surprising move last week, the Los Angeles Lakers announced that they're brining back Phil Jackson to coach the squad he left less than a year ago. Many fans questioned why the Zen skipper would return to a team with Kobe Bryant, a player Jackson described as "un-coachable" – that is until it was announced he would be paid between $25-$30 million **guaranteed** over three years.

Many basketball insiders predict that Jackson and Bryant won't be able to overcome their tumultuous past and the next three seasons will be disastrous for the Lakers. An equal number believe Jackson will bring 'Showtime' back to L.A. and return the team to their prior glory.

At this point, the Lakers' future is about as predictable as the future of Social Security. Although Jackson won't have to worry about retirement after signing his new contract, many Americans are concerned about Social Security and are planning for their retirement accordingly.

To help in this planning, the IRS will allow Roth contributions to 401(k) and 403(b) plans starting in 2006. Roth contributions were introduced in 1998 strictly for individual retirement accounts (IRAs). Contributions to Roth IRAs are never deductible, however, distributions from Roth IRAs, including any earnings, are completely tax-free. Starting next year, taxpayers may elect to have part or all of their 401(k) or 403(b) contributions receive the same treatment.

While helpful, Roth IRAs are limiting because taxpayers may only contribute $4,000 a year (or $4,500 for taxpayers 50 or older). In addition, taxpayers may not contribute to a Roth IRA if their income exceeds $160,000 for married couples filing jointly or $110,000 for single taxpayers. Roth contributions to 401(k) or 403(b) plans will not be subject to these restrictions, however, the maximum Roth amount a taxpayer may contribute is $15,000 (or $20,000 for taxpayers 50 or older).

To accommodate these new Roth contributions, companies that administer 401(k) or 403(b) plans will have to perform additional accounting, including opening a new account to separate Roth contributions and their earnings from traditional contributions. Further, on a regular basis administrators will be required to separately allocate gains and losses between the Roth contribution account and other accounts under the plan. Obviously, increased accounting requirements for administrators will almost certainly result in increased administration fees.

In addition to increased accounting, another disadvantage of Roth contributions to 401(k) and 403(b) plans is employers cannot match employee contribution. That means that the only amounts that will be in the Roth account are the employee's post-tax contributions and the related earnings on those contributions.

Roth contributions to 401(k) and 403(b) plans are scheduled to expire at the end of 2010. Therefore, starting in 2011, prior Roth contributions may remain in the plan, but no new Roth contributions can be made.

At first glance, many taxpayers may not consider making Roth contributions to their 401(k) or 403(b) plan because they would prefer to make a deductible contribution now, anticipating they will be in a lower tax bracket when they retire. However, there is no guarantee that the IRS won't raise tax brackets by the time those taxpayers retire. Plus, taxpayers may have fewer itemized deductions during retirement they can use to reduce taxes.

Essentially, the IRS doesn't care if you pay now or pay later, as long as they get their cut. How Zen.