



Reconsidering the Roth 401(k)

This article reconsiders the Roth 401(k) option, in light of recent developments, including the Pension Protection Act of 2006 and issuance of the final Roth 401(k) regulations. It builds on a March 31, 2005 article by the author titled "The Upcoming 401(k) Dilemma" and an outline prepared for the May 3-5, 2006 Southwest Benefits Association annual meeting titled "The Roth 401(k) Option-From an Employer's Perspective and an Employee's Perspective." The March 31, 2005 article can be found at http://benefitslink.com/2005/2005_04_11_retirement.html. The 2006 outline can be found at http://benefitslink.com/2006/2006_05_05_retirement.html.

The 2005 article concluded that the uncertainty of the country's difficult financial situation makes the employee's personal decision as to whether a Roth 401(k) election would be beneficial to him very difficult. Accordingly, there was good reason for an employer to choose not to offer the option.

Noted in the 2005 article was the fact that the Bush Administration had announced plans to revamp the U.S. tax system in a revenue-neutral manner. Possibilities then under consideration included a national retail sales tax to replace the income tax system. The article said that if such a replacement system was implemented, absent some sort of tax equalizer, those persons who had made the Roth 401(k) election would lose.

In November of 2005, the President's Advisory Panel on Federal Tax Reform issued its report. For several reasons, the Panel rejected replacing the income tax with a national retail sales tax. Included in the reasons for rejection were the likelihood of substantial evasion and the needs for the tax rate to be high and an exemption (and cash grants) to be significant in order for such a tax to be as progressive as the current income tax system.

Federal Financial Problems. Very important to the Roth decision is the future tax system of the U.S. It will turn, in large part, on the financial situation of the federal government. In testimony before the Senate Budget Committee on January 11, 2007, Government Accountability Office (GAO) Comptroller General David Walker said:

"We are on an imprudent and unsustainable long-term fiscal path, and while the short-term deficits have improved in recent years, the long term is getting worse every second of every minute of every day and the time for action is now."

In testimony before the Senate Budget Committee on January 18, 2007, Federal Reserve Chairman Ben Bernanke said:

". . . [O]ne might look at these projections and say, 'Well, these are about 2030 and 2040 and . . . so we don't really have to start worrying about it yet.' But, in fact, the longer we wait, the more severe, the more draconian, the move difficult . . . the adjustments are going to be. I think the right time to start is about 10 years ago."

The following information and charts produced by the GAO show the difficulties that the U.S. is facing.



Figure 1: Unified Surpluses and Deficits as a Share of GDP under Alternative Fiscal Policy Simulations

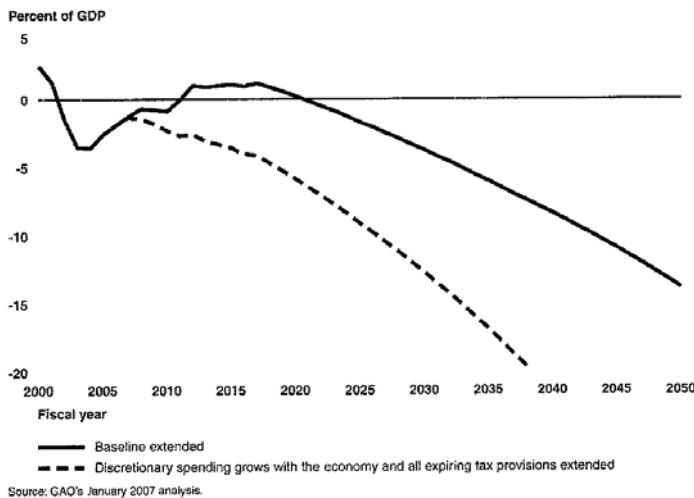
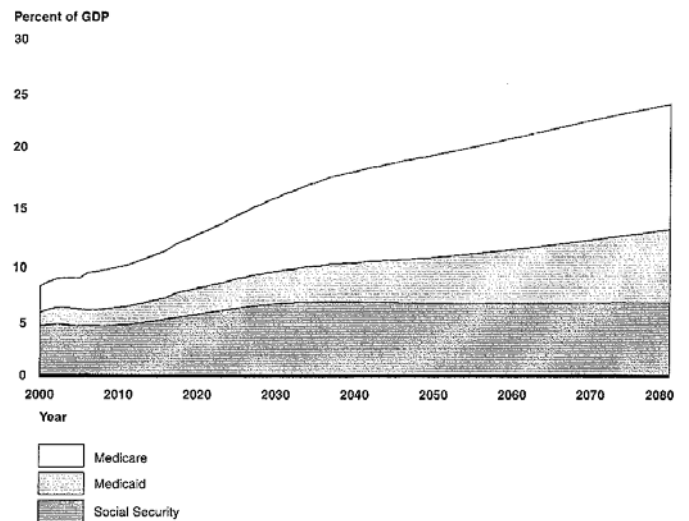


Figure 4: Social Security, Medicaid, and Medicare as Share of GDP, 2000-2080



According to a May 2, 2007 publication of the GAO, explicit liabilities of the federal government grew from \$6.9 Trillion in 2000 to \$10.4 Trillion in 2006 – a 52 percent increase. Debt owed to the public now equals approximately \$5 Trillion. The present value of the unfunded liabilities (i.e. liabilities which would not be funded by our present tax system) grew from \$13 Trillion in 2000 to \$38.8 Trillion in 2006 – a 197 percent increase. The total debts and the present value of all federal unfunded liabilities amount to approximately \$50.5 Trillion, which breaks down to \$400,000 per full-time worker and \$440,000 per household. Also according to the GAO, the *total* U.S. household net worth was \$53.5 Trillion in 2006. The median household income for 2005 was \$46,326.

Some studies have shown that retirees “outvote” young voters 4-to-1. So, the financial problems are tremendous. The issues then become: (a) will entitlements and/or the government in general be cut and, if so, when and by how much?; and (b) how will the government be financed in the future? These issues are germane to a participant’s decision about a Roth election.

Analysis Under the Current Tax System. The 2006 outline summarized the proposed regulations and then provided some calculations of the benefits of the Roth 401(k) election relative to the benefits of a traditional 401(k) plan deferral. Probably the most significant finding of the analysis and calculations was that a comparison of the employee participant’s current incremental income tax bracket to the incremental income tax bracket anticipated in retirement may not be determinative of how a traditional 401(k) deferral contribution and a Roth 401(k) contribution compare. Rather, aspects of the income tax system—in particular, the way that Social Security income is taxed (i.e. the greater a person’s taxable income, the greater the amount of his Social Security income that is taxed)—need to be analyzed with respect to the employee’s personal situation.

The sample calculations from the 2006 outline and the conclusions drawn therefrom follow.

Sample Calculations. Assume a net-of-tax amount of \$10,000 is contributed in 2006 by an employee who is age 58, the employee is presently in a 29.5% combined federal/state incremental bracket, the employee retires and takes lump-sum distribution at age 65, and earns 10% per year, inside and outside the 401(k) plan for all years prior to the distribution.

I.	<u>Traditional (Pre-tax)</u>	<u>Roth</u>
Contribution	\$14,184	\$10,000
Income tax savings (29.5%)	<u>(4,184)</u>	
Net Outlay	10,000	10,000
Growth:		
Contribution	14,184	10,000
Earnings ¹	<u>13,457</u>	<u>9,487</u>
Total	27,641	19,487
Withdrawal at various combined incremental rates:		
29.5%: (27,641 x .705)	19,487	19,487
16%: (27,641 x .84)	23,218	19,487
36%: (27,641 x .64)	17,690	19,487

Note: The break-even tax rate in retirement is 29.5%. Note that this rate is exactly equal to the incremental rate applicable when earned. Most people anticipate being in a lower incremental income tax bracket during their retirement years.

End of analysis? No! Assume \$20,000 is contributed in 2006 by an employee who is age 58, the employee is presently in a 32% combined federal/state incremental bracket, the employee retires and takes lump-sum distribution at age 65, and earns 10% per year, inside and outside the 401(k) plan.

II.	<u>Traditional (Pre-tax)</u>	<u>Roth</u>
Contribution	\$20,000	\$20,000
Income tax savings (32%)	<u>(6,400)</u>	
Net Outlay	13,600	20,000
Growth:		
Contribution	20,000	20,000
Earnings ²	<u>18,975</u>	<u>18,975</u>
Total	38,975	38,975
Withdrawal at various combined incremental rates:		
32%: (38,975 x .68)	26,503	38,975
Add: Savings on \$6,400 ³	<u>10,144</u>	
Total	36,647	38,975
16%: (38,975 x .84)	32,739	38,975
Add: Savings on \$6,400 ³	<u>10,144</u>	
Total	42,883	38,975
36%: (38,975 x .64)	24,944	38,975
Add: Savings on \$6,400 ³	<u>10,144</u>	
Total	35,088	38,975

Note: The break-even tax rate in retirement is 26.027%, because $(38,975 \times .73973) + 10,144 = 38,975$. Note that this rate is substantially lower than the incremental rate applicable when earned.

End of analysis? ...No! Assume the person in Calculation II (in a net 32% bracket) contributed \$20,000 each year from age 58 in 2006 to age 64 in year 2012 and attained age 65 in 2013. Assume annual earnings (inside or outside the plan) of 10% until 2013, and 8% thereafter. The person would thus have accumulated \$208,699 of Roth 401(k) benefits or \$208,699 of traditional 401(k) benefits. Assume the person: (a) is entitled to \$30,000 of annual pension benefits beginning at age 65; (b) has assets that produce \$8,000 of taxable interest income and fully-taxable (not qualified) dividends in 2014, and this amount is assumed to grow at 2.5% per year; and (c) is entitled to \$18,000 of Social Security benefits in 2014, and this amount is increased 2.5% per year under Social Security's COLA. Further assume that the participant is married, and that the Roth 401(k) benefits are rolled over to a Roth IRA at age 65. The traditional 401(k) benefits are rolled over to a traditional IRA at age 65.

The annual tax savings from a traditional IRA are those supplied in Calculation II (\$6,400 per year), and the earnings thereon are included in the calculations. The participant doesn't take any discretionary distributions from the IRA (Roth or traditional). Mandatory §401(a)(9) distributions are made from the traditional IRA after attainment of age 70½. The participant dies shortly after his spouse dies at age 80, and the IRA's proceeds (Roth or traditional) are distributed to the participant's children and/or grandchildren. (The participant's spouse was his designated death beneficiary prior to her death.) The comparison below is of a Roth 401(k) plan's benefits to a traditional 401(k) plan's benefits, given the minimum distributions under a pre-tax plan following attainment of age 70½. Importantly, note that Roth distributions are not taken into account for income taxation of Social Security purposes, while distributions from a traditional IRA increase the amount of Social Security income that is taxable.

III.	<u>Traditional</u>	<u>Roth</u>
Total Contributions and Earnings ⁴	208,699	208,699
Accumulation to age 71 @ 8%/year ⁵	331,179	331,179
Withdrawal at age 71 ⁶ (divided by 26.5)	12,497	
Incremental Tax	<u>(5,955)</u>	
Net Received	6,542	
IRA, reduced for 401(a)(9) amount	318,682	331,179
Growth to Next Year (x1.08)	344,176	357,673
Withdrawal at age 72 ⁶ (divided by 25.6)	13,444	
Incremental Tax ⁷	<u>(6,332)</u>	
Net Received	7,112	
IRA, Reduced for §401(a)(9) Amount	330,732	
Growth to Next Year (x1.08)	357,191	386,287
Withdrawal at age 73 ⁶ (divided by 24.7)	14,461	
Incremental Tax ⁷	<u>(6,734)</u>	
Net Received	7,727	
IRA, Reduced for §401(a)(9) Amount	342,730	
Growth Next Year (x1.08)	370,148	417,190
Withdrawal at age 74 ⁶ (divided by 23.8)	15,552	
Incremental Tax ⁷	<u>(7,176)</u>	
Net Received	8,376	
IRA, Reduced for §401(a)(9) Amount	354,596	
Growth Next Year (x1.08)	382,964	450,565
Withdrawal at age 75 ⁶ (divided by 22.9)	16,723	
Incremental Tax ⁷	<u>(7,655)</u>	
Net Received	9,068	
IRA, Reduced for §401(a)(9) Amount	366,241	
Growth Next Year (x1.08)	395,540	486,610

Continued

Withdrawal at age 76 ⁶ (divided by 22.0)	17,979	
Incremental Tax ⁷	<u>(8,174)</u>	
Net Received	9,805	
IRA, Reduced for §401(a)(9) Amount	377,561	
Growth Next Year (x.1.08)	407,766	525,539
Withdrawal at age 77 ⁶ (divided by 21.2)	19,234	
Incremental Tax ⁷	<u>(8,692)</u>	
Net Received	10,542	
IRA, Reduced for §401(a)(9) Amount	388,532	
Growth Next Year (x1.08)	419,615	567,582
Withdrawal at age 78 ⁶ (divided by 20.3)	20,671	
Incremental Tax ⁷	<u>(9,225)</u>	
Net Received	11,446	
IRA, Reduced for §401(a)(9) Amount	398,944	
Growth Next Year (x1.08)	430,860	612,989
Withdrawal at age 79 ⁶ (divided by 19.5)	22,095	
Incremental Tax ⁷	<u>(9,744)</u>	
Net Received	12,351	
IRA, Reduced for §401(a)(9) Amount	408,765	
Growth Next Year (x1.08)	441,466	662,028
Withdrawal at age 80 ⁶ (divided by 18.7)	23,608	
Incremental Tax ⁷	<u>(10,392)</u>	
Net Received	13,216	
IRA, Reduced for §401(a)(9) Amount	417,858	
Growth Until Death ⁸ (x1.02)	426,215	675,269
Tax on Distributions (29.5%)	<u>(125,733)</u>	<u>0</u>
Net	300,482	675,269
Growth of Tax Savings ⁹	170,517	0
Growth of Net Minimum Distributions ¹⁰	<u>126,628</u>	<u>0</u>
Totals to Heirs	<u>\$597,627</u>	<u>\$675,269</u>

Note that the compounded complete tax-free growth has made a Roth 401(k) contribution more valuable than a traditional 401(k) contribution, where the incremental net income tax rate dropped from 32% while working to 20% in retirement.

Every participant will have a different situation. To perform analysis, a significant number of "guesstimates" must be made for future investment returns, future retirement income needs, future inflation and, of course, future tax rates and the future tax system.

Caveat: Primarily because the calculations were done manually, these figures are not 100% accurate. However, the author (who is an CPA and attorney) believes that they are materially accurate.

Implications of Future Changes to the Tax System. The above calculations were done using the current (2005) tax system. Noted in the 2006 outline was that current income tax rates are relatively low compared to the income tax rates of the past. For example, adjusted for inflation to the present, the 1954 federal income tax rate on income in excess of \$58,986 was 34 percent. (Currently, the highest rate is 35 percent.) Adjusted for inflation to the present, in 1954, the incremental income tax rate was 50 percent on income in excess of \$117,967. Thus, if only an income tax system will exist in the future, and not an income tax *and* a sales tax or value-added tax (VAT)¹¹ (as has been the case since enactment of the income tax in 1913), and entitlements won't be cut significantly, then, given the financial problems, it is highly likely that income tax rates will increase substantially in the future. In that case, if the increase was applied to all income levels pro rata, then there is a very good chance that the majority of participants would benefit from a Roth 401(k) election. In contrast, if entitlements won't be cut substantially, and a sales tax or a value-added tax (VAT) will be implemented *in addition* to the income tax, then the value of the Roth election could turn on the amount of the sales tax or VAT (i.e. the

higher the sales tax or VAT rate, the lower the income tax rates would need to be, and the less likely it is that a Roth 401(k) election is the better choice). In this regard, a 2000 memo of the Chief of Staff of the Joint Committee on Taxation concerning the proposed "Fair Tax" revenue-neutral rate said that studies from other jurisdictions show that the evasion rate becomes substantial when a sales tax rate exceeds ten percent (10%). If entitlements will be cut substantially, would the current tax system remain essentially the same as it is today, at least in terms of tax rates and brackets? Past experience suggests not.

Concerning the possibility of a sales tax or a VAT to supplement the income tax, a major fight can be anticipated when such a proposal is first raised-and it will be raised. Concerning a sales tax, the Chief Counsel of the Joint Committee on Taxation stated in her 2000 memorandum that the "revenue neutral" rate would need to be 59.5 percent for the first five (5) years after enactment, if the tax replaced current income, payroll and estate and gift taxes. Similarly, the President's Advisory Panel on Federal Tax Reform said that, simply to replace the income tax, a national sales tax that provided a cash grant to everyone in order to provide relief for lower income persons would need to have a rate of at least 34 percent. The income tax currently produces between 50 to 60 percent of the federal government's revenue. This means that, even at a rate of ten percent (10%), a sales tax would increase federal revenue by only 15-20 percent. If entitlements won't be cut substantially and the remainder of the government will remain approximately the same as it is today, then future tax revenue would not be enough to hold income tax rates constant. Rather, income tax rates will need to increase. This means that, assuming the federal government and entitlements won't be cut substantially, and a VAT will not be added but a sales tax that does not exceed ten percent (10%) will be added, it seems very likely that people in the top one-third (1/3) of earners would benefit from a Roth 401(k) election. Under such a scenario, for reasons explained below, it's likely that most participants age 40 or younger would benefit from a Roth 401(k) election.

In its 2005 report, the President's Advisory Panel on Federal Tax Reform considered a VAT as possible replacement for part of the income tax. The Panel did not reach a consensus with respect to the VAT, but deemed it to be "worthy of further consideration." The Panel's discussion notes: "The VAT has been adopted by every major developed economy except the United States." VAT rates from various countries around the world are as follows:

Argentina	21%
Austria	20%
Brazil	17%
China	17%
Denmark	25%
Finland	22%
France	19.6%
Germany	19%
Italy	20%
Norway	25%
Russia	18%

Japan maintains a five percent (5%) sales tax. All of these countries have an income tax (often, similar to the U.S. system) in addition to their VAT (or, with respect to Japan, sales tax). Keep in mind that the U.S. spends on defense approximately what the rest of the world combined spends on defense.

To replace *current* revenue, the Panel determined that a 15 percent tax-inclusive VAT (17.6 percent, on a tax-exclusive basis) coupled with a simplified income tax system with a maximum rate of 15 percent, would *currently* work. The Panel noted that to provide the progressiveness of the current system, lower income and middle class individuals and families would need to receive tax credits.

The Panel rejected the creation of a VAT to replace part of the income tax. Part of its reasons are as follows:

The Partial Replacement VAT proposal would add a major new federal tax without eliminating any existing taxes from the federal system. One important factor in the Panel's decision not to recommend the Partial Replacement VAT proposal was several Panel members' concern about how introducing a supplemental VAT might affect the size of the federal government in the medium or long run. These Panel members were concerned that adding a VAT on to the current income tax structure could, over time, lead to growth of federal outlays as a share of GDP – as the tax rate of the Partial Replacement VAT could rise, or corporate and individual income tax rates could return to their present levels. The Panel members who were concerned about this possibility viewed growth in the government's share of the economy as undesirable. Other Panel members were not concerned about this possibility, either because they were more confident that Congress would use the VAT only to offset existing taxes, or because they believed that allowing some growth in tax revenues as a share of GDP would offer a means to finance the growing cost of entitlement programs.

The last sentence provides information that is pertinent to the Roth election.

Because a VAT would carry less evasion than a sales tax, it is a more likely alternative than a sales tax. If a VAT would be implemented in the future, and entitlements and government in general will not be cut substantially in the future, the question then becomes how much the future VAT rates and/or income tax rates would increase to pay for the government's spending needs? Concerning permanency and rate increase potential, the Panel said:

Some members of the Panel who opposed a Partial Replacement VAT suggested that once a VAT was enacted, it would never be repealed. International experience suggests that few countries retreat from a VAT, and that VAT rates generally do not decline. These Panel members were unwilling to support the Partial Replacement VAT proposal given the lack of conclusive empirical evidence on the impact of a VAT on the growth of government.

Given the size of the U.S. economy, a 15 percent VAT, such as that considered by the President's Advisory Panel on Federal Tax Reform, would produce a lot of revenue. But, consider that federal taxes typically comprise about 16 to 20 percent of Gross Domestic Product (GDP). Then, consider the charts previously supplied of anticipated entitlement spending, assuming no cuts in entitlements. By 2040, entitlements alone are anticipated to comprise of approximately 18 percent of GDP. Then consider all of the ordinary costs of the federal government, including national defense. These non-entitlement costs currently substantially exceed the costs of entitlements. For the 2004 fiscal year, entitlement spending was 36 percent of federal spending and non-entitlement spending was 64 percent of federal spending. Federal taxes made up 16.3 percent of GDP in 2004. Thus, non-entitlement spending amounted to 10.4 percent of GDP. Adding 18 percent and 10.4 percent produces **28.4** percent. Not a pretty sight.

According to the Congressional Budget Office (CBO), for the 2006 fiscal year, federal taxes comprised 18.4 percent of GDP. If a ten percent (10%) sales tax on goods and services would produce revenue equal to seventeen percent (17%) of total federal revenue, then growth of revenue as a percentage of GDP due to addition of a 10 percent sales tax would be from 18.4 percent of GDP to 21.5 percent of GDP. The remaining 6.9 percent (i.e. 28.4-21.5) would very likely need to be sourced from the income tax or the FICA tax. Assuming it would be sourced from the income tax, given international competitive pressure, it's unlikely that the corporate income tax could be increased substantially. That would leave the individual income tax. According to the CBO, for the 2006 fiscal year, the individual income tax produced 43 percent of federal revenue. This means that the individual income tax revenue equaled 7.91 percent of GDP (i.e. .43 x 18.4). To add an additional 6.9 percent of GDP would mean that the amount of income tax collected would need to almost double. Under such a scenario, if the burden was shared across the board by all taxpayers pro rata, then most participants would benefit from a Roth election. If a fifteen percent (15%) VAT was proposed (instead of a 10 percent sales tax), it would presumably apply only to sales of goods, and not to sales of goods and services. The result would not be dramatically different.

The above conclusions need to be tailored to an individual's age. In 2030, entitlements are anticipated to be approximately 15 percent of GDP. Thus, someone age 36 in 2007 might use the above analysis (as is), whereas someone age 56 in 2007 might reduce the anticipated increase in taxes to account for the fact that most of his retirement income will be received while the GDP entitlement percentage is closer to 15 percent than to 18 percent. Of course, none of the

above analysis is valid if the federal government (including entitlements) will be significantly smaller than its projected size.

For some people, making a Roth election very likely is the best course of action, regardless of the future size of the government or taxes. People in this group include:

- students, and other young people in a low (or no) incremental tax bracket
- very wealthy people
- people who don't make much now, but very likely will make a lot of money in the future (e.g. a medical intern)
- someone who does not currently pay income taxes

Interestingly, a May 10, 2007 article by PLANSPONSOR.com reported that a recent Harris Interactive/Wall Street Journal survey showed that Americans are willing to support initiatives that require employers to expand health care coverage, but are unwilling to pay more taxes to cover more people under Medicaid and Medicare. Specifically, more than three-quarters (76%) supported a measure requiring employers to give health care to their workers. However, only twenty-six percent (26%) of poll respondents said that they were willing to pay more taxes to expand health insurance coverage.

Given the large number of retirees in the future and the tremendous amount of taxable distributions from various types of qualified plans and IRAs, query whether political pressure will exist to reduce the income tax rate on ordinary distributions? At one point, the long-term capital gains rate applied to distributions. (Some distributions remain potentially subject to the long-term capital gains rate.) If the tax rate on retirement distributions will be less than the rate applied to non-retirement income, will the difference be enough to make a Roth election a bad choice (in hindsight)?

The financial problems of the federal government very likely will hurt the U.S. economy. There has been a tremendous shift in recent years towards defined contribution plans and away from defined benefit plans. This shift puts pressure on defined contribution accounts (which are often participant-directed with respect to investments) to earn solid investment returns in order for the participant's retirement income to be sufficient. If the U.S. economy is hurt, then stock market returns of domestic companies will be hurt as well.

The bottom line to most participants is: the Roth election is essentially a gamble based on future unknowns. It is unlikely that those unknowns—i.e. the amount by which entitlements will be reduced in the future (if any), the future income tax rates and the future tax system—will become known in the foreseeable future. Hopefully, the Roth 401(k) election gains the certainty of no additional taxes on the amount contributed or its earnings with the realization that, in hindsight, the election could be a bad choice. Query whether the federal financial situation will get so bad that the federal government will attempt to tax all retirement benefits, including Roth benefits, in some additional manner?

Is it Worth Adding? From a participant's perspective, the Roth 401(k) concept is relatively simple: Elective contributions are not tax-deductible for income tax purposes and, as long as the money is held for a specified period of time, all distributions are tax-free. On the employer's side, a substantial apparatus must be created to deal with separate accounts, different distribution coding, etc. While most employers probably would like to give employees the Roth option, they do not want to add the additional complexity if relatively few employees are going to make the election.

According to an April 2007 report by the Vanguard Center for Retirement Research, during 2006, the Roth 401(k) was adopted by 14 percent of Vanguard plans, and 5 percent of participants within those plans made the Roth election. Thus, so far, there have not been many takers at either the employer or the employee level of decision-making. However, Vanguard expects 33 percent of the 401(k) plans of its clients to have adopted the Roth 401(k) option by the end of 2007. Presumably, other investment services providers have had, and will have, experiences similar to Vanguard's experience. A recent article from Deloitte also suggests that implementation by employers will grow.

The Pension Protection Act of 2006. Two things of potential significance have occurred due to enactment of the Pension Protection Act of 2006 ("PPA"). First, the Roth 401(k) option was made permanent. This change in law increased the value of the Roth 401(k) option. Second, PPA changed the law relating to rollovers, by allowing nonspouse beneficiaries to roll over benefits via direct rollover *if* the plan so allows. Such a rollover from a Roth 401(k) plan account apparently is not permissible. This law change slightly decreased the value of the Roth 401(k) option vis-à-vis the value of the traditional 401(k) option, because high bracket "bunching" can be avoided and continued tax deferral can be achieved by nonspouse traditional 401(k) beneficiaries. Thus, in the preceding 2006 calculations (III.), the value of a traditional 401(k)

election would be increased if the benefits were paid from a plan (instead of an IRA) and the plan allowed direct rollovers by nonspouse beneficiaries, because a nonspouse beneficiary could roll over the benefits for continued tax-free growth while being able to take distributions over time.

Final Roth 401(k) Regulations. The final Roth 401(k) regulations were issued in April of 2007. Corrections were issued on June 5, 2007. These regulations were effective on April 30, 2007, and they apply to taxable years beginning on or after January 1, 2007. They include few significant changes from the proposed regulations.

Like the proposed regulations, the final regulations apply a 5-year wait rule to a Roth IRA that receives a rollover from a Roth 401(k) plan, even though the benefit under the Roth 401(k) plan met the 5-year rule applicable under Internal Revenue Code Section 402A(d)(2) necessary for the distribution to be a qualified distribution. The preamble provides guidance on how to get around this problem: establish a Roth IRA five or more years prior to receiving the qualified distribution from the Roth 401(k) account and then roll over the Roth 401(k) distribution to the Roth IRA. Obviously, this planning technique will not always be possible.

Under the final regulations, as under the proposed regulations, nonqualifying distributions (i.e. that don't meet the 5-year rule) continue to be subject to apportionment based on the ratio of contributions to the total account balance. With respect to reemployed veterans under the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), a plan may allow a participant to designate the year to which a contribution relates. If so, and a designation is made, that designation will apply for purposes of the 5-year rule. Otherwise, the contribution relates to the first year for which a Roth contribution could have been made. If a 60-day rollover is made to a Roth IRA, but less than the entire distribution is rolled over, then the amount that is rolled over is deemed to come first from the amount that is includible in gross income. A direct rollover generally is necessary for a plan-to (Roth 401(k))-plan rollover.

Concerning the \$200 rollover right (under which a participant with the benefit of \$200 or more must be given the right to elect a direct rollover), a Roth account and pre-tax accounts can be treated separately, and the \$200 limit applied to each account. The same separate treatment rule applies for purposes of the automatic rollover rules—i.e. if the Roth balance and/or the pre-tax balance does not exceed \$1,000, such balance need not be automatically rolled over, even though the combined balance may exceed \$1,000.

In conclusion, the uncertainties of the future financial situation and the future tax situation of the federal government prevent employees from being able to gauge the value of a Roth election. Thus, many employers will decide that they are just not worth the hassle. However, it appears that utilization of the Roth 401(k) option will grow slowly over time at the plan sponsor level.

¹ $(14,184 \times 1.10^7) - 14,184 = 13,457$; $(10,000 \times 1.10^7) - 10,000 = 9,487$

² $(20,000 \times 1.10^7) - 20,000 = 18,975$

³ Assuming an annual tax rate of 32%, the after-tax return on a 10% return would be 6.8%; $6,400 \times 1.068^7 = 10,144$. Note the assumption of a constant 32% combined rate for all years. (It is assumed that the \$6,400 of tax savings could not be saved in an IRA on a tax-deductible basis.)

⁴ $(20,000 \times 1.10^7) + (20,000 \times 1.10^6) + (20,000 \times 1.10^5) + (20,000 \times 1.10^4) + (20,000 \times 1.10^3) + (20,000 \times 1.10^2) + (20,000 \times 1.1) = 208,699$.

⁵ $(208,699 \times 1.08^8) = 331,179$.

⁶ Utilizing the Uniform Lifetime Table.

⁷ This amount is the excess of the traditional tax scenario over the Roth tax scenario. The tax brackets, personal exemptions, Social Security income tax provisions and the standard deduction have been indexed for inflation at 2.5% per year. A 5% State rate is assumed. The incremental federal rate for all years with respect to the traditional 401(k) is 15%. The only deductions are for personal exemptions and the age 65 or older (taxpayers and spouse) increased standard deduction exemption.

⁸ Assume he dies 3 months into the year, and no tax is due.

⁹ This savings is the original savings produced by making a traditional 401(k) contribution, instead of a Roth 401(k) contribution. It was \$6,400 per year. The savings have been grown to retirement age by 1.068% per year, and have been grown by 1.064% (i.e. $1 + (0.08 \times 8)$) thereafter until age 71 (assuming a 10% return rate and a 32% tax rate pre-retirement and an 8% return and a 20% tax rate post-retirement); no tax reduction is made after age 71 (so, the growth is 8% per year), since the incremental taxes on these savings were taken out in the annual incremental tax calculations above.

¹⁰ The minimum distribution amount for each year has been grown by 1.064% (i.e. $(1 + (.08 \times 8))$) for each year.

¹¹ Under a VAT, a tax is levied at various phases of production of a good, starting with raw materials and ending with the final sale. Each Seller in the chain recoups the tax that it paid when it charges the next buyer.