

TIAA-CREF institute

## TRENDS AND ISSUES

### *The Expanding “Roth” Retirement Account*

Alicia Waltenberger, Douglas Rothermich, and  
William Reichenstein  
March 2006

## TRENDS AND ISSUES

[www.tiaa-crefinstitute.org](http://www.tiaa-crefinstitute.org)

### EXECUTIVE SUMMARY

Starting in 2006, many plan participants may have a new vehicle for retirement savings, called the Roth 401(k) or Roth 403(b). Traditional 401(k)/403(b) accounts, which have been offered by employers for several decades, allow participants to tax deduct contributions and defer income taxes on those contributions and the earnings thereon until distributions are made. Distributions are taxed at the owner/beneficiary's ordinary income tax rate at the time of the withdrawal. With Roth 401(k)/403(b) accounts, in contrast, the contributions are not tax deductible, but subsequent returns are tax-exempt (assuming the account has been in existence for five years and the owner has reached the age of 59½ or met other specific circumstances).

Plan sponsors who already offer traditional 401(k)/403(b) accounts to their employees are not required to offer the new Roth option. For those who do, participants will need to decide whether to make contributions to the traditional account, the new Roth account, or some combination of the two.

Consideration of your current and future income tax rates is an important factor in deciding whether to contribute to the traditional accounts or the new Roth accounts. If you expect to have a lower tax rate in retirement, you likely will want to contribute to a traditional 401(k)/403(b). Conversely, if you expect to have a higher tax rate in retirement, you likely will want to contribute to a Roth account. Mathematically, if the tax rates are the same at the time of contribution and distribution, the after-tax wealth is identical with traditional and Roth accounts. If you believe your current and retirement tax rates will be similar, then other factors may determine whether you should prefer to save in the traditional or Roth account.

Another important consideration is that Roth 401(k)/403(b) accounts effectively allow greater contributions than traditional accounts. Although both the traditional and the new Roth accounts allow a maximum contribution of \$15,000 per year (or \$20,000 for individuals age 50 and over), the traditional account contribution consists of *before-tax* funds, while the new Roth account contribution consists of *after-tax* funds. The \$15,000 of after-tax funds is functionally a larger contribution than \$15,000 of pre-tax funds. To compare apples to apples and assuming a 30% rate, a \$15,000 contribution of pre-tax funds to a traditional account is equivalent to a \$10,500 contribution of after-tax funds to a Roth account, since they will produce the same amount of after-tax savings at

## TRENDS AND ISSUES

[www.tiaa-crefinstitute.org](http://www.tiaa-crefinstitute.org)

retirement. (A \$20,000 traditional contribution is equivalent to a \$14,000 Roth contribution.) In short, the Roth account effectively permits a larger contribution.

This paper discusses the most relevant factors to help participants make the decision between funding a traditional 401(k)/403(b) account or a Roth 401(k)/403(b) account. Factors that increase the attractiveness of the Roth 401(k)/403(b) include:

- You are in a lower income tax bracket now than you expect to be during retirement.
- You are willing to accept lower take-home pay now in order to maximize the amount of after-tax savings that will be available at retirement.
- You want to minimize required distributions after age 70½ (Section 3 discusses planning for required minimum distributions with Roth IRAs).
- You have more retirement assets in tax-deferred accounts like the traditional 401(k)/403(b) than in taxable accounts.
- You are concerned about estate tax issues.
- You currently do not itemize deductions or have deductions subject to Adjusted Gross Income (AGI) limits.
- You suspect distributions in retirement from traditional 401(k)/403(b) accounts will subject your Social Security income to taxes.

Factors that tend to favor the use of traditional 401(k)/403(b)s include:

- You are in a higher income tax bracket now than you expect to be during retirement.
- A reduction in this year's AGI would be beneficial for tax planning purposes.
- You believe the United States is going to a flat tax or consumption tax.

In many ways, the new Roth 401(k)/403(b) accounts are similar to Roth IRA accounts: Contributions to these accounts are not tax deductible but returns (e.g., distributions in retirement) are generally income tax-exempt. However, the Roth IRA, which became available in 1997, has income thresholds that prohibit participation by higher-income individuals and impose contribution limits that are far lower than those in employer-provided plans. In contrast, the new Roth 401(k)/403(b) accounts do not have income thresholds and allow much larger contributions.

In sum, under the right circumstances the new Roth accounts allow participants significantly more flexibility in their tax planning and may be worthy of consideration by those who have access to them.

# TRENDS AND ISSUES

www.tiaa-crefinstitute.org

## TABLE OF CONTENTS

Evolution Of Roth Accounts .....	4
Participant Decision-Making Factors .....	5
1. <i>Comparative Income Tax Rates</i> .....	6
2. <i>Maximum Savings Levels</i> .....	8
3. <i>Required Minimum Distribution Rules</i> .....	9
4. <i>Tax Factors</i> .....	9
5. <i>Impact On Estate Taxes</i> .....	10
6. <i>Impact On Itemized Deductions</i> .....	11
7. <i>Social Security Benefits</i> .....	11
Summary .....	11
Appendix – Evolution Of Retirement Plans .....	12
Biographies .....	15

## EVOLUTION OF ROTH ACCOUNTS

For decades, Americans have saved for retirement through tax-deferred accounts – e.g., traditional IRAs, 401(k) or 403(b) retirement accounts. The taxes on funds contributed to such plans, and on returns accumulating inside the plans, are deferred until plan assets are distributed to the owner in retirement (or to beneficiaries following the owner’s death). Distributions from these traditional accounts are fully subject to income tax. In 1997, taxpayers were given a new retirement savings option with a very different approach – the “Roth IRA.”<sup>1</sup> Unlike traditional IRAs (with *tax-deferred* contributions and accumulations, and *taxable* distributions), contributions to a Roth IRA are not tax-deferred – the contributed amounts are fully subject to income tax in the contribution year. However, when an individual begins withdrawing Roth IRA assets in retirement, all withdrawals (of both the original principal amount and any returns inside the

<sup>1</sup> The Roth IRA was named after its principal sponsor and leading advocate, Senator William Roth of Delaware.

## TRENDS AND ISSUES

[www.tiaa-crefinstitute.org](http://www.tiaa-crefinstitute.org)

account) can generally be distributed income tax-free to the individual (or to her beneficiaries after death).

In the short time since its inception, the Roth IRA has grown in popularity. Today, approximately one in eight U.S. households owns at least one Roth IRA.<sup>2</sup> Beginning in 2006, employers may (but are not required to) expand their retirement plan offerings beyond the traditional 401(k) or 403(b) to include the new Roth 401(k) or Roth 403(b). The Roth 401(k)/403(b) includes the same attractive tax-free distribution features as the Roth IRA, but it has fewer eligibility restrictions for higher-income employees and higher contribution limits.<sup>3</sup>

The extent to which Roth 401(k)/403(b) accounts will become available is likely to remain unclear for some time. Employers need to weigh the benefits of these new Roth accounts against their increased recordkeeping costs. Unless Congress extends the law permitting contributions to new Roth accounts beyond its scheduled expiration in 2010, employers may have some reluctance to expand their retirement plans. However, a recent study by Hewitt Associates, Inc. reports that more than 30% of employers surveyed said they are very likely or somewhat likely to add the new Roth account to their defined contribution plans.<sup>4</sup>

### **PARTICIPANT DECISION-MAKING FACTORS**

The introduction of the Roth IRA and its Roth-style expansion to 401(k)/403(b) plans has brought confusion to many taxpayers. In choosing between a traditional retirement account and a Roth retirement account, they need to compare the benefits of the Roth account's tax-free withdrawals to the traditional account's tax deferral of contributions. To determine if a traditional retirement account or a Roth retirement account is more appropriate, much of the analysis hinges upon your applicable income tax rates now and at the time the assets will be withdrawn in retirement (or your beneficiary's income tax rates for distributions after your death). Other factors that may affect the choice between these two accounts are specific to each individual's circumstances.

---

<sup>2</sup> Investment Company Institute, "IRA Ownership in 2004," *Fundamentals*, Vol. 14, No. 1, February 2005.

<sup>3</sup> For additional information on the historical development of tax-advantaged retirement vehicles, please see the Appendix.

<sup>4</sup> Andrea Coomles, CBS Marketwatch, September 6, 2005. The study was conducted by Hewitt Associates, Inc.

# TRENDS AND ISSUES

www.tiaa-crefinstitute.org

## 1. COMPARATIVE INCOME TAX RATES

In general, distributions from Roth retirement accounts are tax-free if (i) the account has been in existence for at least five years, and (ii) the owner has attained age 59½.<sup>5</sup> If a distribution fails to meet these requirements, it may be subject to ordinary income taxes.<sup>6</sup> Assuming that a Roth-style account will qualify for income tax-free withdrawals, a comparison of advantages and disadvantages of Roth and traditional accounts is significantly aided if one has access to the proverbial crystal ball for predicting future income tax rates.

As Figure 1 demonstrates, if your personal income tax rates are the same in the contribution year and the withdrawal year, there is not a relative tax advantage to either a Roth or traditional account. Column A compares a \$10,000 pre-tax contribution to a traditional account with a \$7,000 after-tax contribution to a Roth account when the combined federal plus state tax rates in the contribution and withdrawal years are 30%. The \$10,000 pre-tax contribution to the traditional account decreases taxable income by the same amount, which decreases taxes by \$3,000. It is useful to separate the \$10,000 of pre-tax funds into \$3,000 tax savings plus \$7,000 of after-tax funds. Therefore, the \$10,000 contribution to the traditional account and \$7,000 contribution to the Roth account are comparable in that they both represent \$7,000 of after-tax contributions and both decrease this year's spending by \$7,000. Figure 1 assumes they are both invested in the identical asset that earns 6% per year for 20 years. At withdrawal, the \$10,000 pre-tax in the traditional account has grown to \$32,071 pre-tax or, after paying taxes at 30%, \$22,450. The \$7,000 of after-tax funds in the Roth account has grown to \$22,450 after taxes. In short, both the \$10,000 contribution of pre-tax funds to the traditional account and the \$7,000 contribution of after-tax funds to the Roth account decrease contribution year's spending by \$7,000 and increase withdrawal year's spending by \$22,450. So, when the tax rates in the contribution year and withdrawal year are the same, neither the traditional account nor Roth account has a relative tax advantage.

---

<sup>5</sup> The five-taxable-year period for an individual's Roth 401(k)/403(b) account begins on the first day of the tax year for which she made her first contribution to that account (or a predecessor account in the case of a rollover from another Roth account). For example, if she first makes a contribution to a Roth 403(b) in 2006 then the holding period for this Roth begins on January 1, 2006. When a beneficiary inherits a Roth, her beginning date is the same as the owner's. That is, the five-year period does not start anew except in the case of a rollover from a Roth 401(k)/403(b) to a Roth IRA.

<sup>6</sup> Distributions are also tax-free if: (i) the account has been in existence for at least five years, and (ii) they occur after the owner's death, the owner is disabled, or for certain first-time home purchases (this last exception applies to Roth IRAs only, not to Roth 401(k)/403(b) plans).

## TRENDS AND ISSUES

www.tiaa-crefinstitute.org

Column B demonstrates that when the withdrawal year's tax rate is lower, the traditional IRA, 401(k) or 403(b) account provides greater after-tax wealth. In this example, the tax rate falls from 30% in the contribution year to 20% in the withdrawal year. In the traditional account, taxes on the \$32,071 withdrawal are \$6,414, which leaves \$25,657 after taxes. This amount is \$3,207 higher than the Roth's after-tax value, and the \$3,207 difference is due to the 10% lower tax rate on the \$32,071 withdrawal from the traditional account.

Column C demonstrates that when the withdrawal year's tax rate is higher, the Roth account provides greater after-tax wealth. In this example, the tax rate rises from 30% in the contribution year to 40% in the withdrawal year. In the traditional account, taxes on the \$32,071 withdrawal are \$12,829, which leaves \$19,242 after taxes. This amount is \$3,207 lower than the Roth's after-tax value, and the \$3,207 difference is due to the 10% higher tax rate on the \$32,071 withdrawal from the traditional account.

**Figure 1 – Impact of Tax Rate Changes of Use of Roth account vs. Traditional Account**

	Column A		Column B		Column C	
	Same Income Tax Rate		Lower Income Tax Rate in Retirement		Higher Income Tax Rate in Retirement	
	Roth	Traditional	Roth	Traditional	Roth	Traditional
Contribution Tax Rate	30%	30%	30%	30%	30%	30%
Withdrawal Tax Rate	30%	30%	20%	20%	40%	40%
Pre-Tax Contribution		\$10,000		\$10,000		\$10,000
After-Tax Contribution <sup>6</sup>	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000	\$7,000
Withdrawal Amount	\$22,450	\$32,071	\$22,450	\$32,071	\$22,450	\$32,071
Income Tax on Withdrawal	\$ - 0 -	\$9,621	\$ - 0 -	\$6,414	\$ - 0 -	\$12,829
<b>After-Tax Withdrawal</b>	<b>\$22,450</b>	<b>\$22,450</b>	<b>\$22,450</b>	<b>\$25,657</b>	<b>\$22,450</b>	<b>\$19,242</b>

Figure 1 suggests that a major factor—likely the most important factor—influencing the choice between a traditional and Roth account is the relationship between the current tax

<sup>6</sup> A \$10,000 contribution to a traditional account is equivalent to a \$7,000 after-tax contribution to a Roth account, assuming an income tax rate of 30%.

## TRENDS AND ISSUES

[www.tiaa-crefinstitute.org](http://www.tiaa-crefinstitute.org)

rate and the expected tax rate during retirement. If you expect to be in a lower income tax bracket during retirement (Column B), the traditional IRA, 401(k) or 403(b) should be favored. If you expect to be in a higher tax bracket during retirement (Column C), the Roth 401(k)/403(b) should be favored. Finally, if you expect to leave funds in traditional or Roth accounts to a beneficiary then the relevant comparison is between your contribution year's tax rate and the beneficiary's expected tax rate at withdrawal.

### **2. MAXIMUM SAVINGS LEVELS**

Under current tax law, the maximum contribution to a traditional 401(k)/403(b) or a Roth 401(k)/403(b) is \$15,000 (or \$20,000 for individuals age 50 and above). However, the traditional account contribution consists of *before-tax* funds, while the new Roth account contribution consists of *after-tax* funds. To compare contributions to these two types of accounts, return to the assumptions in Column A, where the investor is in the 30% tax bracket in the contribution and withdrawal years. In this case, a \$15,000 traditional contribution is equivalent to a \$10,500 Roth contribution in that they both represent the same amount of after-tax funds today and in retirement. (And a \$20,000 traditional contribution is equivalent to a \$14,000 Roth contribution.) Therefore, a \$15,000 contribution of *after-tax* funds to a Roth is effectively a larger contribution than a \$15,000 contribution of *pre-tax* funds to a traditional account. Based on the assumed tax rates, this benefit of the Roth account is relevant only to those individuals who will save more than \$10,500 of after-tax funds this year.

Let's consider an example where an individual wants to save more than \$10,500 of after-tax funds. Assume the individual is under age 50, in the 30% tax bracket now and in retirement, and wants to save \$15,000 of after-tax funds this year. She considers two strategies: 1) save \$15,000 in the Roth account or 2) save \$15,000 pre-tax in a traditional account plus \$4,500 in a taxable account. Both strategies require investments of \$15,000 of after-tax funds; since the \$15,000 contribution to the traditional account is equivalent to \$10,500 of after-tax funds, this strategy requires an additional saving of \$4,500 in a taxable account. If she will be in the 30% or higher tax bracket in retirement (e.g., Column A or C) then she should save in the Roth because all \$15,000 of after-tax funds would grow tax exempt in the Roth. In contrast, only the \$10,500 of after-tax funds in the traditional account would grow effectively tax-exempt, while the \$4,500 in the taxable account would be subject to taxes. If she will be in a lower tax bracket in retirement (e.g.,



## TRENDS AND ISSUES

www.tiaa-crefinstitute.org

Column B), then she must weigh the benefits of the lower tax rate for the traditional account against the fact that the \$4,500 in the taxable account would be subject to taxes.<sup>7</sup>

### 3. REQUIRED MINIMUM DISTRIBUTION RULES

Technically, Roth 401(k)/403(b) accounts must comply with the same required minimum distribution (RMD) rules as their traditional counterparts – meaning that RMDs must begin at the later of separation from service or age 70½, with the minimum distribution amount based on the size of the account and one’s life expectancy, using the IRS tables. In contrast, funds in a Roth IRA are not subject to RMDs during the owner’s lifetime. In a potentially valuable planning opportunity, a Roth 401(k)/403(b) account owner can roll over a distribution from a Roth 401(k)/403(b) account into a Roth IRA, where it will not be subject to RMDs during her lifetime.<sup>8</sup> This strategy may provide years of additional tax-free growth, and is especially beneficial to individuals who might not have the ability to establish a Roth IRA through a regular contribution or a conversion contribution (i.e., from a traditional IRA) due to the AGI limits imposed on such contributions.

### 4. TAX FACTORS

#### A. Tax Diversification: Mix of Pre-Tax and After-Tax Assets

Suppose someone believes she is about equally likely to be in a lower or higher tax bracket during retirement, but she already has most of her retirement assets in tax-deferred accounts. If so, she may wish to invest in the Roth account as a form of tax diversification. Since most of her wealth will be subject to her income tax rates during retirement, she can diversify the risk of a high retirement tax rate by investing in a Roth account today. Just as individuals hedge against investment risk, they can hedge against the uncertainty of future tax rates by having some assets taxed at today’s tax rate (Roth accounts) and some assets taxed at retirement rates (traditional accounts).

Tax diversification may be especially important to higher-income employees because they cannot save through Roth IRAs and thus most of their retirement assets may be in traditional tax-deferred accounts. A married couple filing jointly cannot contribute to a

---

<sup>7</sup> Employer matching contributions should not affect the choice between contributing to a traditional account or Roth account. The matching contribution is generally calculated on the dollar value of the employee’s contribution. The employer’s matching contribution will have to go into a traditional account, but the employee’s contribution can go into either type of account.

<sup>8</sup> See Proposed IRS Regulations Section 1.408A-10, A-2.

## TRENDS AND ISSUES

[www.tiaa-crefinstitute.org](http://www.tiaa-crefinstitute.org)

Roth IRA if their adjusted gross income (AGI) exceeds \$160,000, while a single cannot contribute if her AGI exceeds \$110,000. In contrast, there are no income limits that restrict contributions to Roth 401(k)/403(b) plans. Furthermore, contribution limits to a Roth 401(k)/403(b) plan are much higher — \$15,000 for 2006 or \$20,000 if age 50 or older — than the limits for Roth IRAs — \$4,000 for 2006 or \$5,000 if age 50 or older.

### B. Adoption of a Flat Tax or Consumption Tax

There is uncertainty regarding the future of federal income taxes. Some individuals believe that the United States may institute a flat tax or a consumption tax. If this were to occur, the flat tax or consumption tax rate could be lower than the marginal income tax rates in effect today, and it is unclear how distributions from income tax-deferred retirement accounts would be taxed, if at all. Given this, a traditional account could be favored over a Roth account if such dramatic changes occur to our tax system.

## 5. IMPACT ON ESTATE TAXES

During the past several years, it has become increasingly difficult to predict if there will be an estate tax in the future, and if so, at what level of gross estate it may apply. There has been significant interest among many in Congress to repeal the estate tax and the current administration came to Washington with promises to eliminate or curtail the imposition of this tax. The 2001 tax law established a schedule of periodic increases in the size of estates that can be sheltered from estate tax. In 2006, taxable estates under \$2 million incur no estate tax. That amount increases to \$3.5 million in 2009, and the tax is completely repealed in 2010 – but only for that year. Under current law, the estate tax exclusion amount is scheduled to revert to \$1 million in 2011 and beyond. Many commentators, including this paper's authors, believe Congress will take further action to alter this schedule. Based on current sentiments in Congress, we suspect that the exclusion amount will be permanently increased to at least \$2 million and probably closer to \$5 million.

At these levels, most individuals do not have large enough estates to worry about estate taxes. Those who do, however, may wish to compare the after-income-and-estate-tax result of saving in a Roth account versus a traditional account. Estate tax laws do not adequately distinguish between pre-tax and after-tax dollars. Although there is some adjustment for the fact that a traditional account is subject to income and estate taxes, the adjustment is not always adequate. Thus, in some instances, taxpayers net more

## TRENDS AND ISSUES

[www.tiaa-crefinstitute.org](http://www.tiaa-crefinstitute.org)

after-income-and-estate-tax dollars from having a Roth account instead of a traditional account.

### **6. IMPACT ON ITEMIZED DEDUCTIONS**

If you itemize deductions for income tax purposes, you know that some deductions are limited to expenses in excess of a percentage of your AGI. For example, medical expenses are deductible for income tax purposes to the extent they exceed 7.5% of AGI. Deductions for business expenses, casualty losses and investment expenses are also limited to amounts exceeding a percentage of AGI. If you itemize deductions and have any deductions subject to these AGI limitations, it may be a factor in choosing between Roth and traditional IRA, 401(k) or 403(b) accounts. Because contributions to a Roth account do not reduce taxable income in the contribution year, your current-year's AGI will be higher if you choose a Roth account instead of a traditional account. For example, if you have earned income of \$100,000 and choose to contribute \$15,000 to a retirement account, your taxable income will be \$100,000 if you contribute to a Roth 401(k)/403(b) account or \$85,000 if you contribute to a traditional 401(k)/403(b). The Roth account creates a higher AGI, and therefore higher thresholds for income tax deductions. Any potential loss in deductions as a result of funding a Roth account instead of a traditional 401(k)/403(b) account should be factored into your analysis.

### **7. SOCIAL SECURITY BENEFITS**

Qualified distributions from Roth accounts are tax-exempt and thus will not affect the taxation of Social Security benefits, while distributions from traditional accounts are taxable and thus may affect this taxation. Therefore, everything else the same, individuals and couples who believe distributions from traditional accounts will affect the taxation of their Social Security benefits should favor the Roth accounts.

### **SUMMARY**

For many individuals, it is not easy to determine if the advantages of a Roth account outweigh its disadvantages. Frequently, the most important factor influencing the choice between a Roth account and traditional account is the relationship between the tax rates in the contribution year and withdrawal year. If you expect to be in a higher bracket during retirement, you should favor the Roth account, and vice versa. If you expect to be

## TRENDS AND ISSUES

[www.tiaa-crefinstitute.org](http://www.tiaa-crefinstitute.org)

in the same or similar tax bracket, other factors might affect your choice. Advantages of the Roth account include:

- 1) a maximum contribution to a Roth account will produce greater after-tax savings than a maximum contribution to a traditional account;
- 2) required minimum distributions from Roth accounts generally can be avoided during your lifetime, and
- 3) distributions from Roth accounts will not affect the taxation of Social Security benefits.

Advantages of the traditional account include the possibility that the deductible contributions will reduce your current year's AGI and thus increase certain itemized deductions.

### APPENDIX – EVOLUTION OF RETIREMENT PLANS

From the earliest development of legislation to encourage retirement savings, U.S. tax law focused on tax-deferred savings – allowing taxpayers to defer recognition of income on funds directed to such accounts. The history of such tax-deferred retirement savings legislation dates back to the Revenue Acts of 1921 and 1926, which allowed employers to deduct pension contributions from corporate income, and allowed for income in the pension fund to accumulate tax-deferred. Participants in such plans realize no income until distributions are made from the pension plan.

Tax-deferral continued to be the focus in 1958 when Congress established the 403(b) plan, which encouraged employees of certain tax-exempt organizations to save for retirement. Named after the authorizing section of the Internal Revenue Code, this plan offered a salary-deferral retirement program for employees of educational institutions and certain other non-profit organizations. In 1974, the Employee Retirement Income Security Act (ERISA) created the traditional IRA. This original IRA legislation permitted eligible employees under the age of 70½ to contribute to an IRA the lesser of \$1,500 or 15% of compensation. In addition, it allowed employees in employer-sponsored retirement plans to transfer, or roll over, plan assets into the IRA when retiring or changing jobs. The Revenue Act of 1978 established the 401(k) plan, which extended to private-sector employees the ability to save in salary-deferred retirement accounts. Over this span of decades, Congress encouraged employees to save for retirement by allowing a portion of their pre-tax compensation to be directed to an IRA or a qualified employer-sponsored retirement plan.

## TRENDS AND ISSUES

[www.tiaa-crefinstitute.org](http://www.tiaa-crefinstitute.org)

As noted earlier, this focus on tax-deferred plans changed in 1997 when Congress added the Roth IRA to the mix. The Roth IRA is effectively the mirror image of traditional retirement accounts. In the Roth IRA, the contribution is not deductible so the taxpayer must recognize income in that year, but returns (interest, dividends and capital gains inside the plan) are generally income tax-free. The traditional tax-deferred plans can be thought of as front-loaded retirement plans, while Roth accounts are back-loaded plans. The tax break for traditional accounts occurs at the front end with the tax savings from the deductible contribution. The tax break for the Roth plans occurs at the back end with the tax exemption of returns.

Although potentially appealing to many taxpayers, income limitations restricted Roth IRAs to lower- and middle-income taxpayers and contribution limits further restricted amounts flowing into Roth IRAs (see the chart below for income and contribution limits). In 2004, Americans held approximately \$12.9 trillion in tax-deferred retirement plans. Of the \$3.5 trillion held in IRAs, less than 4% was held in Roth IRAs (approximately \$120 billion).<sup>9</sup> Despite their small share of the retirement market, there is evidence that Roth IRAs are becoming increasingly popular. In recent years, over 30% of all assets contributed to IRA accounts have gone into Roth IRAs.<sup>10</sup> Because of its less restrictive eligibility requirements and larger contribution limits, the new Roth 401(k)/403(b) may fuel significant growth in Roth retirement accounts.

---

<sup>9</sup> Investment Company Institute, "Mutual Funds and the U.S. Retirement Market in 2004," *Fundamentals*, vol. 14, No. 4, August 2005.

<sup>10</sup> Peter Sailer and Sarah Holden, Use of Individual Retirement Arrangements to Save for Retirement – Results From a Matched File of Tax Returns and Information Documents for Tax Year 2001 (2004).

## TRENDS AND ISSUES

www.tiaa-crefinstitute.org

## Comparison of Roth IRA and Roth 401(k)/403(b)

	Roth IRA	Roth 401(k)/403(b) Plan
<i>Created Thru Contributions:</i>		
Employer/Compensation Income	The individual must have compensation income for the year of contribution <sup>11</sup>	The plan has to be offered by the employer. Contributions only allowed by employee's elective deferrals <sup>12</sup>
Income Limit	Modified AGI must be less than: (i) \$160,000 if married filing jointly or qualifying widow(er); (ii) \$110,000 if filing single, head of household, or married filing separately and live apart from spouse entire tax year <sup>13</sup>	There is no income limit.
Contribution Limit	Lesser of \$4,000 (\$5,000 if age 50 or older) for 2006 or compensation income, minus contributions to traditional IRA for year <sup>14</sup>	The 2006 limit is \$15,000 (\$20,000 if age 50 or older) <sup>15</sup>
<i>Created Thru Conversion:</i>		
If Married, Tax Filing Status	If married, must be married filing jointly unless lived apart from spouse entire tax year, then married filing separately accepted	
Income Limit	Modified AGI of individual (couple, if married) must be less than \$100,000 <sup>16</sup>	
Plans NOT Eligible for Conversion	Inherited IRA <sup>17</sup> and traditional 401(k)/403(b) plans <sup>18</sup>	

<sup>11</sup> Compensation income includes wages, commissions, self-employment income, professional fees, tips, and taxable alimony and maintenance payments; but does not include gifts or pension, annuity or deferred compensation payments.

<sup>12</sup> There is no provision for employer matching on an after-tax basis or other contributions by employers to these accounts on an after-tax basis for their employees. However, employers can make pretax contributions to match employee Roth contributions.

<sup>13</sup> Modified adjusted gross income (modified AGI) is based upon an individual's adjusted gross income, as stated on her personal income tax return, which is then increased and decreased by certain deductions and exclusions.

<sup>14</sup> In 2007, the dollar limit remains at \$4,000, or \$5,000 for an individual age 50 and older. In 2008-2010, the dollar limit is \$5,000, or \$6,000 for an individual age 50 and older. After 2010, the dollar limit is scheduled to revert to \$2,000 for all individuals. The dollar limit is gradually phased out between modified AGI of \$150,000 and \$160,000 for married filing jointly and \$95,000 and \$110,000 for other filers.

<sup>15</sup> These amounts are reduced by the amount of pre-tax contributions made by the employee during the year.

<sup>16</sup> Modified AGI does not include required minimum distributions from IRAs or qualified retirement plans.

<sup>17</sup> An inherited IRA from a spouse only qualifies for conversion if the spouse elects to treat the IRA as her own.

<sup>18</sup> They can, however, be rolled over to a traditional IRA and then traditional IRA can then be converted to a Roth IRA, subject to the income and tax filing limits. Assets from a Roth 401(k)/403(b) plan can be rolled over directly to a Roth IRA.

## TRENDS AND ISSUES

[www.tiaa-crefinstitute.org](http://www.tiaa-crefinstitute.org)

### BIOGRAPHIES

Alicia Waltenberger, J.D., serves as a Wealth Planning Specialist for TIAA-CREF. In this role, her responsibilities include providing high net worth client's sophisticated wealth transfer planning and tax services. Prior to joining TIAA-CREF, Ms. Waltenberger practiced law as an associate with Polsinelli Shelton Welte Suelthaus PC (formerly Suelthaus and Walsh, P.C.) in St. Louis, Missouri. Her practice focused on estate planning, trust and probate estate administration, lifetime gifting techniques, business succession planning, and individual, corporate and transfer tax planning. Alicia received her Juris Doctor cum laude from Saint Louis University in 2002 and her Bachelor of Science in Business Administration with a concentration in Finance and Banking from University of Missouri-Columbia in 1996.

Douglas Rothermich, J.D., serves as Vice President – Wealth Planning Services for TIAA-CREF where he manages a group of estate planning attorneys and financial planning specialists who deliver wealth planning and tax services to high net worth TIAA-CREF participants. Prior to joining TIAA-CREF, he practiced law in St. Louis with the firm of Bryan Cave, LLP, a national and international law firm. He has also served as Vice President and Senior Trust counsel at Boatmen's Trust Company, accumulating estate planning and trust experience and expertise. Mr. Rothermich is active in several professional organizations and is a frequent author or contributor to TIAA-CREF publications. He received his law degree cum laude in 1992 from St. Louis University School of Law and is a 1984 graduate of the University of Missouri, St. Louis, where he received his Bachelor of Arts degree magna cum laude in Business Administration with an emphasis in Finance and Economics.

Dr. William Reichenstein, CFA, holds the Pat and Thomas R. Powers Chair in Investment Management at Baylor University. He is an Associate Editor of *Journal of Investing*, on the Editorial Board of *Journal of Financial Education*, on the Editorial Review Board of *Journal of Financial Planning*, on the Advisory Board of *Journal of Wealth Management*, and Contributing Editor-Portfolio Strategies for (American Association of Individual Investors) *AAII Journal*. Also, he is a TIAA-CREF Institute Fellow.