Could a Roth IRA be Better Than a 401(k)?

By Terry Mitchell

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Very few people whom I know are familiar with the benefits of the Roth IRA. It was named for the late Senator William Roth of Rhode Island, who proposed it. It is similar to a traditional IRA except contributions are never tax-deductible. Contributions to traditional IRAs are sometimes deductible or partially deductible, depending on your income and whether or not you have a retirement plan like a 401(k) at work. With Roth IRAs, individuals are limited to incomes of $95,000 ($150,000 for couples) to be eligible for full contribution amounts.

However, unlike the traditional IRA, you can withdraw your contributions from a Roth IRA at any time, at any age without penalty. Earnings are not taxed if you wait until at least age 59 1/2 to begin withdrawing them and have held your Roth IRA for at least five years. With a Roth IRA, the contributions are taxed without any deferment, but they grow tax-free and the gains are never taxed (see above). With a 401(k), contributions are tax-deferred, but eventually the contributions and gains will be taxed. By the time most people retire, the earnings from their retirement accounts will far exceed their contributions, due to compounding. With that in mind, one could make the case for a Roth IRA possibly being better than a 401(k).

Here's an illustration. Let's suppose that over the course of 25 years you contributed a total of $75,000 to your 401(k) and your employer kicked in $30,000 during that same period for a total of $105,000. By the end of those 25 years, your compounded gains (assuming you're getting a decent rate of return) could total $500,000. When you retire, you will eventually pay taxes on the entire $605,000 as well as the gains you receive from it after retirement. Now, let's assume that, instead of contributing to your 401(k) for those 25 years, you contributed only $50,000 to your Roth IRA (without a matching contribution from your employer, of course). The assumption is also that you would not be able to contribute as much because you are using post-tax dollars for the Roth IRA vs. pre-tax dollars for the 401(k). However, because you generally have more investment options with the Roth IRA money than with the 401(k) money, you are likely to find a better rate of return. With that in mind, let's say your compounded gains could total $400,000. When you retire, you could have the entire $450,000 as well as the gains you could receive from it post-retirement, completely tax free!

As you can see, it is possible that many people could come out better putting at least a portion of their retirement funds into a Roth IRA. Judge for yourself. I actually contribute more to my Roth IRA than I do to my 401(k). I put just enough into my 401(k) to get my employer's maximum matching contribution, and that's all. However, I'm not a financial advisor and I don't play one on TV, so check with your financial advisor to see what would be right for you. For more information about the Roth IRA, see the following link: http://www.rothira.com.

Terry Mitchell is a software engineer, freelance writer, and trivia buff from Hopewell, VA. He also serves as a political columnist for American Daily and operates his own website - http://www.commenterry.com - on which he posts commentaries on various subjects such as politics, technology, religion, health and well-being, personal finance, and sports. His commentaries offer a unique point of view that is not often found in mainstream media.

New retirement savings plan - Roth 401(k) coming into effect

By Lance Williams

The Retirement savings plan, Roth 401(k) introduced by the Economic Growth and Tax Relief Reconciliation Act, 2001 will come into force from January 2006. Unlike a traditional 401(k) Retirement Plan, a Roth 401k plan applies to all employees but the latter requires the contributions to the plan account with after-tax dollars while a 401k plan allows for contributions with pre-tax dollars.

You may not be allowed to contribute to a Roth IRA if your income level is higher but you can certainly qualify for a Roth 401(k) plan, as there are no income specifications here. In addition, you can contribute up to $15,000 for 2006, as in a 401(k) plan and the limit reaches $20,000 for individuals turning 50 years of age or older by the end of the year. The increase in the limit is termed as the catch-up contribution which was a provision of the Economic Growth and Tax Relief Reconciliation Act of 2001.

As far as the employers' contributions are concerned, these amounts will be matching the contributions of employees but with pre-tax dollars. The employer contribution will be rolled up in a separate account and funds withdrawn from that account will be subjected to taxes on withdrawal.

The Roth 401(k) plan may not allow you to get the benefit of the contribution from pre-tax dollars but it allows you to withdraw tax-free money after retirement. You can avoid paying income tax on the cash you withdraw from your plan account after retirement. But your age should be 59 and ½ years and you should have held the plan account for more than 5 years or more. In case you withdraw money before retirement, you will have to pay taxes (almost 35% of the contribution) and a 10% penalty.

A Roth 401(k) plan can be helpful as it prevents you from tax payments on withdrawal after retirement. But this will help you only if your tax bracket after retirement is same or higher than what it is now. If your current tax bracket is low, then you can contribute more towards the Roth 401(k) plan account. Your savings thus increase and you get to withdraw a higher amount at retirement. You can also roll over your Roth 401(k) balance into a Roth IRA whenever you leave your employment.

You can contribute a part of the allowed limit, which is $15,000 to a Roth 401(k) plan account and the rest to a 401(k) account, and thereby reduce the tax payments. This is because a Roth 401(k) allows you to contribute after-tax dollars whereas a 401(k) plan account allows for pre-tax contributions.

With a Roth 401(k) plan contribution, you don't take home several dollars since you are allowed to accumulate after-tax dollars into the plan account. But then you don't have to pay taxes on the amounts taken out after retirement and this helps you especially if the tax bracket is higher at that time.

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Lance Williams is working as a content developer for MortgageFit.com. He specializes in mortgage and real estate concepts.

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