Spring 2011

Your Bottom Line

PUBLISHED QUARTERLY BY: MACKENSEN & COMPANY, INC. FEE-ONLY FINANCIAL PLANNERS

Navigating a clear course toward your financial security.

Building a Tax-Free 401(k)

David T. Mayes

The prospect of higher tax rates has many considering the Roth 401(k) option as a potential source of tax-free retirement income.

Roth accounts are a fairly recent addition to 401(k) plans and are offered by only about 29 percent of employers, according to data from Hewitt Associates.

Like Roth IRAs, a Roth 401(k) allows savers to make after-tax contributions to a retirement account, foregoing a current-year tax deduction in exchange for tax-free withdrawals of earnings in the future. As long as earnings are left in the account for five years from the year of the first contribution, and the participant has reached age 59 1/2, no tax is due on distributions.

The Roth 401(k), however, has some advantages over a Roth IRA. Roth IRA contributions are limited to $5,000 annually ($6,000 if age 50 or older), whereas up to $16,500 ($22,000 if 50 or older) may be invested in a Roth 401(k) account. Roth 401(k) contributions are also eligible for employer matching, but these matching funds must go into a traditional, pre-tax 401(k). In addition, the income limits on a Roth IRA do not apply to a Roth 401(k), so even high wage-earners can contribute.

When the Roth option is added to 401(k) plans, participants must decide how to divide their contributions between the traditional (pre-tax) and Roth (after-tax) accounts, determine their contribution rate, and choose investment options. In evaluating how the Roth option may help you meet your retirement goals, you should be aware that Roth and traditional 401(k) contributions will result in the same after-tax retirement account balance as long as your tax rate stays the same before and after retirement.

For example, consider a 401(k) participant in the 25 percent tax bracket who contributes the maximum of $16,500 to her traditional 401(k) account for 2011. Ten years later, assuming an average annual return of seven percent, her 401(k) account would be worth $32,458. After paying taxes due on withdrawing this amount, she is left with $24,344 to spend. If she instead contributes the maximum to a Roth 401(k), she would pay tax on the $16,500 contribution amount up front, leaving only $12,375 in after-tax dollars to invest. Again assuming a seven percent annual return, her Roth account would be worth $24,344 after ten years, the same after-tax amount as in her traditional 401(k).

Given this after-tax equivalence, the decision regarding whether a Roth 401(k) makes sense hinges on what your tax rate will be during retirement, a key aspect to consider as part of your overall retirement plan. This future tax rate will depend on not only what Congress chooses to do with rates but also your other sources of retirement income. If you will rely largely on Social Security, which is only partly taxable, for a large part of your retirement income or you will continue to have significant itemized deductions, you may find yourself in a lower tax bracket in retirement. This tips the scales toward the traditional 401(k), even if Congress raises rates across the board.

Generally, Roth contributions make more sense for younger workers who are currently in a low tax bracket but expect their earnings to increase substantially prior to retirement. For these 401(k) participants, the tax savings provided by traditional 401(k) contributions is relatively small compared to the future tax savings offered by the Roth option. Still, Roth contributions can make sense for higher income earners, particularly if they have been locked out of contributing to a Roth IRA due to income limits. If these workers expect their income needs to keep them in the same tax bracket during retirement, or they anticipate rising rates, having a Roth 401(k) to draw upon, tax-free, can significantly improve their after-tax retirement income. Having both traditional and Roth 401(k) balances provides opportunities for better tax management in retirement. ❖

Retirement Planning Challenging for Women

David A. Batchelder

Women are more highly educated than ever before and, as a result, have better employment prospects and higher earnings potential than their mothers did. When it comes to preparing for a secure retirement, this should be good news. Still, women face several significant challenges that can leave them underprepared for life after work.

Women can expect to spend more years in retirement than men. Women live longer and tend to retire younger in order to coordinate their retirement date with an older spouse. Women also generally earn less than men and experience more career interruptions due to other demands like raising children. These factors detract from their ability to accumulate pension benefits, which are based on earnings and job tenure. With longer retirements, women need more retirement income, but are not likely to get it from a pension.

Married women should also recognize that at some point they may be on their own in retirement, having outlived their spouses. This loss can increase a woman's risk of living in poverty in old age due to higher final expenses and lost pension and social security income.

So what can women do to help secure their retirement?

The first step is universal – start saving early. New college graduates should consider employment offers carefully in terms of overall benefits, not just salary. Look for high matching contributions in a 401(k) plan and immediate vesting. If your 401(k) plan offers a Roth option, use it. The tax benefits of traditional IRA contributions are smaller when you are starting your career.

Second, choose the right investment mix for your retirement account. Surveys suggest that women tend to be more conservative investors, stashing large portions of their nest-egg in low-yielding cash-like investments that may reduce their long-term investment returns. A more balanced approach using a mix of stocks, bonds and other assets can provide more income, better total returns, and help protect purchasing power by offsetting inflation.

Even when taking time out of the workforce, married women should continue to save for retirement by making IRA contributions. A non-working spouse can make a full IRA contribution of $5,000 ($6,000 if age 50 or older) in 2011. As long as a couple's total income is less than $169,000, the contribution will be fully tax deductible, or the funds can go into a Roth IRA.

Give your retirement precedence over college. For moms, college savings for children is often chosen as their highest savings priority. Remember that you have many options for funding your child's education but you cannot borrow for retirement.

If your spouse has a defined benefit pension plan, resist the temptation to take a lump-sum payment. Select a joint and survivor annuity that guarantees that at least half of the pension continues to be paid after your spouse's death. This will mean a smaller monthly payment for both of you, but will provide greater protection against outliving your assets.

Plan to be debt-free at retirement. Having your mortgage retired at the same time you do will provide greater flexibility in your budget.

Finally, married couples should make social security claiming decisions carefully. Social security is the most secure income source for many retirees – it is guaranteed for life and has built-in inflation protection. For couples, it may be beneficial for the higher earning spouse to postpone receiving benefits as long as possible in order to earn delayed retirement credits. These credits can increase monthly benefits by up to 32% over what would be received at full retirement age. Using a "file and suspend" approach in which the husband files for social security at full retirement age but waits until age 70 to start receiving payments can be a valuable way to ensure an adequate lifetime income stream for a future widow. ❖

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