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Saving More With Roth 403(b)s / 401(k)s

By Michael Heller and Benjamin Goodman

The new Roth 403(b)/401(k) plans allow you to save more money and ultimately withdraw it income tax free. TIAA-CREF actuaries Michael Heller and Benjamin Goodman examine how these plans might fit in with your retirement and other long-term goals.

In 2006, some employers began offering participants a new kind of supplemental retirement plan (SRP) — the Roth 403(b) or Roth 401(k) plan. If this new plan is available to you in 2008, your annual contribution limit is generally \$15,500, plus another \$5,000 if you're age 50 or older, for a total maximum of \$20,500. (If your employer offers both 403(b) and 401(k) plans, whether they're both Roth, or both traditional, or one of each, you cannot contribute the maximum to both. However, you can split your contributions among both as you wish.)

Unlike traditional 403(b)/401(k) before-tax contributions, which are credited to your account before you pay any taxes, Roth 403(b)/401(k) contributions are made after taxes, so you don't get a tax deduction for them. However, Roth 403(b)/401(k) earnings become available completely tax free when you're age 59½ or older, and if you hold the account for five or more years, or if you satisfy other "retirement" criteria. But a 10% early withdrawal penalty generally applies to any "nonqualified" withdrawal of earnings before age 59½.

In contrast, traditional 403(b)/401(k) contributions and earnings are only tax-deferred. This means you'll have to pay income taxes on both when you withdraw your money. Of course, pre-59½ withdrawals are subject to the 10% penalty.

The question is, if you can contribute to either Roth or traditional SRPs, or to both, which do you choose?

Should You Choose the Roth 403(b)/401(k)?

On the surface, it appears that if your tax bracket remains the same before and during retirement, there is really no advantage to the Roth over the traditional SRP. But it may be more informative to look at a few hypothetical examples to see how the choice may affect you.

HYPOTHETICAL EXAMPLE 1: You're earning \$50,000 annually and currently make a 10% pretax contribution to your 403(b) supplemental plan. Your \$5,000 contribution reduces your take-home pay by \$3,750, reflecting an assumed 25% marginal tax bracket. If you were to use a Roth 403(b) — which, remember, is an after-tax plan — while keeping your take-home pay at the same level, your Roth contribution would be limited to \$3,750.

Assuming your contribution earns 6%¹ per year, for 20 years, your before-tax traditional 403(b) contribution will grow to \$16,036. However, upon withdrawal, this accumulation will be subject to taxes. The net withdrawal amount would be \$11,225 if you're in the 30% tax bracket, \$12,027 if you're in the 25% tax bracket, and \$12,829 if you're in the 20% tax bracket. On the other hand, if you were to use the Roth 403(b) supplemental plan, your \$3,750 contribution would grow to \$12,027 and you would owe no taxes.

RULE OF THUMB: If you are not maximizing your supplemental plan contributions, your choice of traditional or Roth plan account depends on what you expect your tax rate to be in retirement. Consider the following table as a guide.

If your marginal tax rate in retirement is:	The preferred account is:
Higher than current rate	Roth
Same as current rate	Either one
Lower than current rate	Traditional

HYPOTHETICAL EXAMPLE 2: You're earning \$100,000 and can afford to make the maximum \$15,500 contribution. You are in the 35% marginal tax bracket now and expect to be in the same bracket in retirement, and you want to know if contributing to a Roth 403(b) is the way to go. Assuming that your contribution earns 6% each year for 20 years, your \$15,500 will grow to \$49,711. If you use the Roth 403(b) supplemental plan, that \$49,711 will be yours completely free of any income taxes in retirement.

But if you make the same \$15,500 contribution on a pretax basis to a traditional 403(b) instead, your net after-tax balance will only be \$32,312 because of the income taxes you'll have to pay upon withdrawal. However, you also save \$5,425 in taxes when you contribute the \$15,500 before taxes to the traditional 403(b).

To make this a fairer comparison, then, let's assume that you invest this \$5,425 tax savings in a taxable account. (It cannot be saved in a 403(b) account due to the \$15,500 limit.) By earning the same 6% interest rate less 35% for taxes, the tax savings will only grow to \$11,660 at the end of 20 years. Adding this amount to the traditional 403(b) net amount of \$32,312 leaves you with a total accumulation of \$43,972 — \$5,700 less than the Roth final balance of \$49,711.

Extending this analysis a bit further, even if your tax bracket were to decline in retirement from 35% to 25%, you'd still be better off in the Roth 403(b).

¹The assumed rate is purely hypothetical and not intended to predict the actual performance of any specific investment. An investment's principal value and total return will fluctuate.

RULE OF THUMB: If you can afford to contribute the annual maximum on an after-tax basis and expect to be in the same or higher tax bracket in retirement, the Roth 403(b) is a better plan. The Roth 403(b) may be better even if you find yourself in a lower tax bracket in retirement.

Other Things to Think About

Tax Bracket “Creep.” While many working people realistically expect their retirement income to drop in inflation-adjusted dollars, the effects of tax bracket “creep” over time shouldn’t be overlooked. An example may help explain what tax bracket creep is:

A tax bracket represents the range of income that is taxed at a specific rate. For example, a single person with an income of \$31,850 is taxed at a maximum of 15%. If inflation is 4%, and his/her income increases at the inflation rate, this income will go up to \$33,124. However, if the tax bracket only increases by 3%, some of this income will be taxed at 25%, the next higher bracket. Thus, the individual does not get a “real” increase in pay (because he/she is merely keeping pace with inflation), but ends up paying a higher percentage of income taxes (because some of his/her income moves from a 15% tax bracket into a 25% tax bracket). This is tax bracket creep.

Impact of Budget Deficits. If the federal budget deficit continues, the government may raise tax rates to increase revenue. If this happens, a Roth 403(b) supplemental plan would be preferable because you’d get your money tax free in retirement.

Tax Deduction Issues. Yet another potential advantage of the Roth 403(b) supplemental plan is the ability to “time” distributions in retirement as part of an overall tax strategy. For example, if you have a one-time large financial need, rather than withdraw from a taxable, traditional 403(b) plan and wind up in a higher tax bracket as a result, you can withdraw savings from the Roth 403(b) plan and, again, pay no taxes on it.

On the other hand, the adage “a bird in the hand is worth two in the bush” may apply. The pretax 403(b) supplemental plan offers a definite tax deduction now; the Roth 403(b) supplemental plan offers tax-free withdrawals in the future. By the time retirement arrives, the economic picture may have changed significantly — maybe the United States will institute a flat tax or consumption tax. If either of these were to occur, it might dilute the advantages of the Roth 403(b) plan.

Furthermore, your traditional 403(b) plan deduction lowers your adjusted gross income (AGI). Without this reduction, you may lose out on being able to take your full personal exemptions and other itemized deductions that phase out above certain AGI levels. And lastly, for those individuals who already have a traditional 403(b) plan, having yet another account to manage may become inconvenient.

After considering these scenarios, what's the right plan to choose? It's safe to say that most working people have only a vague idea of how tax brackets may differ in retirement from their tax brackets today. In reality, trying to assess how tax rates may change is guesswork. Given the uncertainty that surrounds this choice, it's likely that many people will hedge their bets and split their contributions between traditional and Roth 403(b) accounts. That is also a reasonable option worth considering.

Learn More About Retirement Savings Options

To learn more about retirement planning and other TIAA-CREF financial services, visit us at www.tiaa-cref.org, **schedule an appointment online**, or call a consultant at **800 842-2776**.

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