<u>The Roth 401(k): Additional Opportunity for the Small Business Owner</u>

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Are you a business owner or an employee of a small business? Perhaps your company is considering installing a retirement plan, or looking for new alternatives to your existing plan. If so, you may be wondering what your options are. There are certainly several to choose from, including a relative newcomer to the retirement plan world. Surely everyone's heard of a 401(k), and most people have heard of the plan for individuals called the Roth IRA, but the new hybrid retirement plan called the Roth 401(k) may be a plan you haven't heard about yet. As its name might imply, the Roth 401(k) is an employer retirement plan combining features of the classic 401(k) with opportunities for post-tax contributions that grow tax-free for the future. If tax-free retirement income is something of interest to you, then read on.

The Roth 401(k) has been around since January 1st of 2006, but wasn't made permanent in legislation until the Pension Protection Act of 2006 was passed in August 2006. Like anything new, it can take some time to learn its benefits and uses.

The Roth 401(k) has some particularly attractive features for proprietors of the owner-only small business, since owners serve as both the working employee and the owner/employer in such an operation. The contribution limits of the Roth 401(k) are the same as a standard 401(k). As the ***employee***, the proprietor may contribute up to $15,500 of salary in 2007. Individuals age 50 and older may contribute a "catch-up" contribution of an additional $5,000 in 2007, totaling a $20,500 maximum contribution. As the ***employer***, the proprietor can make a tax-deductible contribution of up to 25% of earned income to the employee (him or herself). In total, annual contributions can reach as high as $45,000 or 100% of earned income, whichever is less.

The real power of the Roth 401(k) plan occurs for the owner-only business proprietor who is taking home high levels of income. Let's compare the contribution limits of the Roth 401(k) with the Simplified Employee Pension IRA, or SEP-IRA, using a 45-year old proprietor of an owner-only S-corporation business with $100,000 of W-2 income. Both plans allow the same level of ***employer*** contributions: up to 25% of AGI equaling $25,000. However, in the owner-only 401(k) he is also allowed to contribute $15,500 as his employee salary deferral (Roth or pre-tax). Total contributions to the Owner-only 401(k) equal $40,500, while the SEP-IRA only allows maximum contributions of $25,000.

The contribution limits and comparison to the SEP-IRA are actually the same whether you use a standard 401(k) or the Roth 401(k). Where the Roth 401(k) sets itself apart is that it has no income limitations to determine investor eligibility. This can be an important benefit, since many high-income individuals who would like the opportunity to put away dollars for tax-free future income make too much money to utilize a Roth IRA. In 2007, Roth IRA eligibility phases out for a single taxpayer beginning at $99,000, and at $156,000 for a taxpayer filing married filing jointly. If an individual is eligible for a Roth IRA, however, the Roth IRA may be used *in addition* to the opportunity presented by the Roth 401(k). Wow!

The owner-only Roth 401(k) plan is the only plan type that allows both Roth and pre-tax contributions, in any combination of amounts the account holder desires. Contributions are discretionary in any given year, offering maximum flexibility as business income fluctuates. The Roth 401(k), similar to a standard 401(k), does also offer the opportunity for business owners to take tax- and penalty-free loans from the account – up to the lesser of $50,000 or 50% of their account balance.* Another opportunity is that an owner-only 401(k) may be used in conjunction with a SEP-IRA or defined benefit plan. So, a business owner can make the employee deferral to the Roth 401(k) account while continuing to make the employer's tax-deductible contribution to the SEP-IRA or defined benefit plan.

As with everything in life, there's a give and take to consider when choosing whether the Roth 401(k) is right or not. A business owner must choose whether it's better to get a tax deduction today in a standard 401(k), or pay taxes today on the Roth dollars and get tax-free income in the future. A financial professional can assist a business owner with determining which plan makes better sense in the short and long term given individual circumstances.

Other items to consider when determining feasibility of the Roth 401(k) include noting that Roth contributions are irrevocable - once allocated to a Roth 401(k) account, they cannot be shifted to a pre-tax account. Also, "qualified", or tax-free, distributions from the Roth account will be allowed only in the cases of death, disability, or attainment of age 59-1/2 as long as it has been at least five years since the initial Roth 401(k) contribution was made. For nonqualified distributions from Roth accounts, earnings are taxable and may be subject to a 10% early withdrawal penalty. As with any tax situation, consult with your CPA to determine individual tax ramifications.

*With traditional accounts, withdrawals of pretax contributions and earnings which are not taken out as a loan are taxable and may be subject to a 10% early withdrawal penalty if taken before age 59-1/2.