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'06 brings new developments in retirement planning

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A new savings alternative and new bankruptcy rules providing added protection for a debtor's retirement assets may have an effect on your retirement planning as the new year begins.

First, 2006 brings another way to save for retirement: the Roth 401(k), which combines the features of a traditional 401(k) plan with a Roth IRA. With a traditional 401(k), you contribute pre-tax dollars while you're working, and pay income taxes on money withdrawn from the account during retirement. With a Roth 401(k), you contribute after-tax dollars now, and don't pay any taxes on the money you later withdraw.

The Roth 401(k) provides higher-income workers with their first opportunity to create a savings account that allows tax-free withdrawals during retirement. You can fund a Roth 401(k) regardless of how much money you make, and in 2006, you can contribute up to $15,000 to the account.

If you have access to both a Roth 401(k) and a traditional 401(k), you can contribute a total of $15,000 to the two accounts (people age 50 and over by the end of the year may contribute a total of $20,000). You can divide the contribution between the two 401(k) accounts, or allocate the entire contribution to one of them, so long as the total contributed isn't more than $15,000.

A Roth 401(k) also may provide an estate planning opportunity for some high-income workers.

After age 70, you must withdraw a minimum amount each year from both a Roth and a traditional 401(k). However, upon leaving your employer, you may be able to roll over Roth 401(k) funds into a Roth IRA, which does not require annual withdrawals.

If you don't need the money during retirement, the Roth IRA funds can grow tax-free during your lifetime, and then pass to your heirs without being subject to income tax (although they may be subject to estate tax).

A Roth 401(k) is not necessarily a good idea for everyone. According to Ed Hickey, a registered representative with LPL Financial Services in Manchester, the average investor is likely to accumulate more in a traditional 401(k) than a Roth.

If you decide to save $5,000 for retirement, you can invest the entire amount pre-tax in the traditional 401(k), but, for cash-flow reasons, you might be able to invest only $3,500 (the equivalent of $5,000 pre-tax) in the Roth 401(k).

Also, if you'll be in a lower tax bracket during retirement than you are while you're working – which is true for most people, says Hickey – you're better off with the traditional 401(k). But if you think your tax rates will be higher during retirement, and are willing to pay income taxes today in exchange for tax-free withdrawals later, the Roth 401(k) might be a better bet.

Although current income tax rates are relatively low, the budget deficit and cost of funding Social Security and Medicare may drive rates up in the future. Clearly, a visit to your financial adviser is in order before making a final decision about the Roth 401(k).

Bankruptcy law changes

Although the new federal bankruptcy rules are designed to encourage people to repay their debts instead of try to discharge them in bankruptcy, they also shield all qualified retirement accounts from a debtor's creditors in bankruptcy.

The only significant limitation is that the exemption for Roth IRAs and traditional IRAs – other than simplified employee pensions (SEPs) and SIMPLE retirement accounts – is limited to $1 million, plus the amount of all rollovers (and earnings attributable to the rollovers). For this reason, it may be a good idea to keep IRAs funded with annual contributions separate from those funded with rollover contributions. (If you've already commingled your annual-contribution and rollover IRAs, current law does not provide any method for untangling them.)

Since 1999, New Hampshire law has provided an unlimited bankruptcy exemption for any "retirement plan or arrangement qualified for tax exemption purposes." Under the new bankruptcy rules, however, the federal exemption will shelter all tax-favored retirement plans regardless of whether the debtor uses the state or federal exemptions. NHBR

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