Could the Roth 401(k) Be Right For You?

Understanding the differences between the traditional and Roth 401(k)

While the Federal government has created a number of tax-advantaged savings accounts designed to help lower- and middle-income workers save for retirement, these plans tend be less useful for employees earning larger salaries.

But highly-compensated individuals currently not permitted to contribute to Roth IRAs, or younger workers expecting to be in higher tax brackets when they retire, stand to benefit when companies offer employees the option of contributing after-tax dollars to a type of plan called the "Roth 401(k)."

As the name suggests, the Roth 401(k) incorporates elements of both traditional 401(k) plans and Roth IRAs. Included in the Economic Growth and Tax Relief Reconciliation Act of 2001, the Roth 401(k) allows workers to make Roth IRA-type contributions to 401(k) plans, but without the income restrictions and contribution limits that apply to Roth IRAs.

Contribution Guidelines

Contributions to a Roth IRA are nondeductible, but earnings accumulate tax free, and qualifying distributions are also tax free. Currently, only taxpayers whose adjusted gross income falls below certain levels ($137,000 a year for single filers, and $203,000 for joint filers) are eligible to contribute after-tax dollars to a Roth IRA. These income limits do not apply to Roth 401(k)s.

Workers will also have the opportunity to save far more money in the new accounts than they could using Roth IRAs. The 2019 annual contribution limits for IRAs of all kinds are set at $6,000 for taxpayers under the age of 50, and $7,000 for older workers.

The Roth 401(k), in contrast, will be subject to the more generous elective salary deferral limits that apply to conventional 401(k)s – $19,000 for taxpayers under the age of 50, and $25,000 for older workers.

A Few Considerations

The Roth 401(k) has other advantages over the Roth IRA. Contributions are made through payroll deductions, rather than through separate arrangements with a bank. Because these plans are administered by employers, contributing to them should be more convenient for workers than opening an IRA. An employee who is currently contributing to a traditional 401(k) plan could, for example, simply opt to have his or her contributions diverted to a Roth version of the same plan.

Lawmakers have stipulated, however, that matching contributions made by employers must be invested in a traditional 401(k), not a Roth account. This means that, even if employees make all of their contributions exclusively to a Roth 401(k) account, they would still owe tax in retirement on withdrawals from funds contributed on a pre-tax basis by their employers.

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Workers should also be aware that the 401(k) annual deferral limits apply to all 401(k) contributions, regardless of whether they are made on a pre-tax or after-tax basis. If employees contribute to a Roth 401(k), they may have to reduce or discontinue their contributions to their employer's conventional 401(k) plan to avoid exceeding these limits. Provided employees comply with these limits, however, they are allowed to put money into both types of 401(k) plans.

In addition, employees considering the Roth 401(k) option should know that – like the 401(k), but unlike the Roth IRA – the Roth 401(k) will require them to begin taking distributions after the age of 70½. On the other hand, the Roth 401(k) resembles the Roth IRA in that investors will not be permitted to withdraw their money tax free until they have held the account for at least five years and are at least 59½ years old. The latter provision could make the Roth 401(k) less attractive to employees who are currently approaching retirement.

Talk to your financial advisor to see if the Roth 401(k) might be appropriate for you.

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