The Value of the Roth 401(k) Option

As a retirement plan sponsor, you have a decision about whether to add a Roth feature to your existing 401(k) plan. Roth contributions are made in after-tax dollars. But they lay the groundwork for potentially tax-free income in retirement. When added to an already well-rounded 401(k) plan, a Roth feature can help ensure that your organization continues to offer a leading-edge retirement plan to current and future employees.

Because a Roth feature may be especially appealing to certain employees, it can help your organization be competitive in recruiting and retention efforts. A Roth 401(k) may be attractive to several different employee demographic groups. For example, people who expect to be in the same or a higher income tax bracket in retirement may not have to worry about future tax increases. In addition, younger participants may have the time horizon needed to build a potentially sizable tax-free nest egg. Highly compensated employees who are not eligible to contribute to a Roth IRA may find that the Roth 401(k) presents the best opportunity to accumulate assets for tax-free income in retirement.

Now, let’s compare how making equal contributions to a pretax 401(k) and an after-tax Roth 401(k) may affect a plan participant’s retirement income outlook.

Historically speaking, today’s tax rates are considered quite low. For example, during the mid-1960s, the highest income tax rate was 70%. Today, it’s 37%. Of course, you would need a crystal ball to know where tax rates will go in the future.

That’s why a Roth feature may make a lot of sense. It means that future retirees may not have to worry about tax increases. But even if taxes stay where they are, a Roth feature may still be an attractive addition to a retirement savings program.

Let’s look at an example. This table illustrates equal contributions to a traditional pretax 401(k) and an after-tax Roth 401(k) that are invested for 20 years and then distributed over a 20-year retirement. In the pretax example, the participant contributes $15,000 per year and pays no tax during the accumulation phase but pays more than $197,000 in taxes during the distribution phase. The net result is an account worth almost $625,000. That’s not bad.

But now, let’s look at the Roth scenario. In the Roth 401(k) example, the participant again contributes $15,000 over the same time period but pays $72,000 in taxes while contributing. Because Roth distributions are tax free, he pays no taxes during the distribution phase. The net result is an account worth more than $821,000.

In both examples, we assume a 6% annual rate of return before retirement and a 4% annual rate of return during retirement. The tax rate remains a constant 24% during the 40-year time frame. We also assume the investor will have no need for the money prior to retirement. These assumptions are for illustrative purposes and cannot be guaranteed. In addition, this example shows the results of investing all assets in a Roth versus a traditional plan account. But it doesn’t have to be an all-or-nothing scenario.

Participants can split their contributions between Roth and traditional accounts if they determine that's the best approach given their savings goals and tax situation. However, total contributions cannot exceed the maximum amount permitted by the IRS.

For many employees, making Roth contributions could mean more money in their pocket when they retire but less money in their pocket today. However, the decision ultimately will be different for every employee based on their unique circumstances as well as their expectations for the future.

In general, however, the Roth feature offers many potential benefits to employees. Unlike the Roth IRA, there are no income restrictions for making Roth 401(k) contributions. Like a traditional 401(k), the Roth feature allows much higher annual contributions than a Roth IRA and allows an employer match. However, employer match contributions must go into a pretax account.

Also note that there are no required minimum distributions for a Roth 401(k) during the account owner's lifetime. This could clear the way for individuals who wish to pass on a tax-free legacy to future generations.

Finally, by being able to split contributions between a pretax 401(k) and an after-tax Roth 401(k), employees could gain more control over their personal tax liability, both during their working years and in retirement.