Should You Consider a Roth 401(k)?

August 23, 2023

With their tax-free earnings and large contribution limits, Roth 401(k)s could be a useful addition to the retirement-savings toolbox.

Many companies now offer employer-sponsored Roth 401(k) retirement accounts alongside traditional 401(k) plans, giving employees another way to save for retirement. What's the difference between the two accounts? And should you consider opening a Roth 401(k)?

Here, we'll take a look at how Roth 401(k) plans stack up against their traditional counterparts and what to consider before contributing to one.

Roth 401(k) vs. traditional 401(k)

Most people are familiar with how traditional 401(k) retirement plans work: An employee contributes pre-tax dollars and can choose from a variety of investment options. Then, contributions and potential earnings grow tax-deferred until they're withdrawn, usually in retirement.

With a Roth 401(k), the main difference is when the IRS takes its cut. You make Roth 401(k) contributions with money that has already been taxed—just as you would with a Roth individual retirement account (IRA). Any earnings then grow tax-free, and you pay no taxes when you start taking withdrawals in retirement.[1]

Another difference is that if you withdraw money from a traditional 401(k) plan before you turn 59½, you pay taxes and may potentially owe a 10% penalty on the entire distribution.[2] With a Roth 401(k), your non-qualified withdrawals are a pro-rata amount of your contributions and earnings, and you may potentially be subject to the 10% early withdrawal penalty on funds that are considered gross income.[3]

One similarity between Roth and traditional 401(k)s is that you must start taking required minimum distributions (RMDs) once you reach age your RMD age to avoid facing a penalty. However, beginning in 2024, the RMD requirement for Roth 401(k)s will no longer apply due to changes within Secure Act 2.0. This change will allow those assets to have the opportunity to grow tax-free, and if you pass down those Roth assets to your heirs, they won't have to pay taxes on distributions either.

Choosing a Roth 401(k) or a traditional 401(k) might not be an either-or decision. If your employer offers both, you can contribute to a Roth 401(k) and a traditional 401(k). However, keep in mind that your annual contribution limit would apply across both accounts. For example, you can't contribute the 2023 salary deferral limit of $22,500 ($30,000 if you're age 50 or older) to each 401(k). Instead, you must divide the total amount between accounts—for instance, putting $11,000 in a traditional 401(k) and $11,500 in the Roth 401(k). The same goes for your total annual contribution amount ($66,000, or $73,500 if you're age 50 or older), which includes employer matches.

Which account is right for you?

Traditional 401(k)

- **Taxes**: You make pre-tax contributions and pay tax on withdrawals in retirement
- **Salary deferral limits for 2023**: $22,500 ($30,000 if you're age 50 or older)
- **Total contribution limits for 2023** (includes salary deferral amount and employer matches): $66,000 ($73,500 if you're age 50 or older)
- **RMDs**
    - You must take RMDs starting at age 73

Roth 401(k)

- **Taxes**: You make after-tax contributions and don't pay tax on qualified withdrawals in retirement
- **Salary deferral limits for 2023**: $22,500 ($30,000 if you're age 50 or older)

- **Total contribution limits for 2023** (includes salary deferral amount and employer matches): $66,000 ($73,500 if you're age 50 or older)

- **RMDs**
  - For 2023, RMDs are required if you're age 73 or older. Beginning in 2024, RMDs will no longer be required due to SECURE Act 2.0 changes.

Now that you have a better understanding of a Roth 401(k), you might be wondering how it differs from a Roth IRA. Contributions to either account type are made with after-tax dollars, and you won't pay taxes on qualified distributions. The main differences between the two types of Roth accounts come down to contribution limits, income limits, and RMD rules (for tax years 2023 and before).

- IRA contributions limits are much lower than Roth 401(k)s. Roth IRAs are capped at $6,500 for 2023—$7,500 if you're 50 or older.

- Roth 401(k)s don't have an income limit for contributions. You can only make contributions to a Roth IRA if your modified adjusted gross income (MAGI) is less than $153,000 for single filers or $228,000 for married couples filing jointly or a qualified widow(er) for 2023.

- For 2023, Roth 401(k)s must take RMDs if over age 73. However, in 2024, this rule changes and Roth 401(k)s we be treated like Roth IRAs, which means you won't be required to take RMDs.

Finally, a Roth 401(k) is only available through an employer plan. As long as you meet the above MAGI income requirements, you can open a Roth IRA on your own as part of your retirement strategy.

When a Roth 401(k) can make sense

Taxes are a key consideration when it comes to deciding on a Roth 401(k) over a traditional 401(k).

If you're young and currently in a low tax bracket but you expect to be in a higher tax bracket when you retire, then a Roth 401(k) could be a better deal than a traditional 401(k). Think of it this way: With a Roth 401(k), you can get your tax obligation out of the way when your tax rate is low and then enjoy the tax-free earnings later in life.

The same argument can apply to mid-career workers as well, especially those concerned about the prospects for higher tax rates in the future. After all, current tax rates are fairly low by historical standards. The top rate for married couples filing jointly is 37% in 2023, but it was 70% in 1981 and an eye-watering 91% back in 1963.[5]

"On the flip side, it may make less sense to contribute to a Roth 401(k) if you think your tax bracket will be lower in retirement than it is now," Rob said.

And high earners who expect to maintain their income and spending standards into retirement could consider using Roth 401(k)s to simplify their taxes by paying them up front while they're still working.

Covering your bases through tax diversification

If you're not sure where your tax rate, income, and spending will be in retirement, one strategy might be to contribute to both a Roth 401(k) and a traditional 401(k). The combination will provide you with both taxable and tax-free withdrawal options. As a retired individual or married couple with both Roth 401(k) and traditional 401(k) accounts, you could determine which account to tap based on your tax situation.

"You can't really know what future tax rates will look like, so building in the flexibility to use multiple accounts to manage taxes is important and helpful," explained Rob.

For example, you could take RMDs from your traditional account and withdraw what you need beyond that amount from the Roth account tax-free. That would mean you could withdraw a large chunk of money from a Roth 401(k) one year—say, to pay for a dream vacation—without having to worry about taking a big tax hit.

Besides the added flexibility of being able to manage your marginal income tax bracket, reducing your taxable income in retirement may be advantageous for a number of reasons, including lowering the amount you pay in Medicare premiums, paring down the tax rate on your Social Security benefits, and maximizing the availability of other income-based deductions. Be sure to weigh all your available options to maintain your retirement goals.

[1] Individuals must have the Roth 401(k) account established for five years and be over the age of 59½ for tax-free withdrawals.

[2] Individuals separating from service on or after the year that they turn 55 are exempt from the 10% penalty.

[3] To be a "qualified distribution" the following rules must be met: 1) You have reached age 59½ (or have died or become disabled), and 2) At least five years have passed since the first day of the calendar year in which you first made a Roth contribution to the retirement plan.

[4] Rolling over a Roth 401(k) balance to a new Roth IRA may restart the five-year qualification period. The qualification period would then be calculated from the initial deposit into the IRA and the rollover will be eligible for tax-free withdrawals when that five-year period has ended (and the age qualifier has been met).

[5] The Tax Foundation, 3/22/2017.