# Choosing Between Traditional and ROTH 401(k)'s

## Choosing Between Traditional and Roth 401(k)s

The Roth 401(k) may appeal to workers willing to forgo a tax break now in return for getting one at retirement. As its name implies, the Roth 401(k) combines features of a traditional 401(k) with those of a Roth IRA.

As with a traditional 401(k), workers enjoy the convenience of contributing through payroll deduction. But as with a Roth IRA, contributions are made on an after-tax basis, and withdrawals after age 59½ are tax free and penalty free for workers who have maintained their account for five tax years. Designated Roth 401(k) may also be added to 403(b) plans, which are commonly used by schools, hospitals, and government entities.

## How a Roth 401(k) Works

The Roth 401(k) follows many of the same rules as a traditional 401(k). For the 2018 tax year, federal laws permit a maximum annual contribution of $18,500, although your employer may impose a lower limit. Your employer may provide a matching contribution as part of a Roth 401(k), but any matching contributions must be separately accounted for, and distributions from that account will be subject to taxation. If you are age 50 or older, you may contribute an additional $6,000 to a designated Roth 401(k) for a total contribution of $24,500 in 2018.

You may continue to maintain a traditional 401(k) while directing all or a portion of new contributions to a Roth 401(k). Your contributions to a Roth 401(k), however, are irrevocable—once made, they cannot be transferred to a traditional 401(k) account. Your plan may allow you to make in-plan rollovers from a traditional 401(k) account to a designated Roth 401(k), but any previously untaxed amounts will be subject to taxes in the year of conversion. Generally, both Roth and traditional 401(k)s require minimum distributions after age 70½.

## Planning for Retirement

A Roth 401(k) may present a significant benefit when it's time for retirement—the funds can be rolled over directly to a Roth IRA with no tax payment. Assets in a traditional 401(k) can also be converted to a Roth IRA,

but the conversion requires you to pay taxes on the portion of the rollover that has not yet been taxed.

## Roth vs. Traditional 401(k)s: A Quick Comparison

The table below presents a summary of the most important differences between Roth and traditional 401(k)s.

| | Traditional 401(k) | Roth 401(k) |
|---|---|---|
| **Tax Status of Contributions** | Pretax contributions reduce current taxable income. | After-tax contributions do not affect current taxable income. |
| **Tax Status of Distributions After Age 59½** | Taxed as current income but penalty free. | Tax free and penalty free for investors who have had the account for at least five tax years. |
| **Rollovers to IRAs** | May be rolled over directly to a traditional IRA. May be rolled over to a Roth IRA, but distributions will be subject to income taxes on any previously untaxed amounts. | May be rolled over directly to a Roth IRA. |

## To Roth or Not to Roth?

If you're considering a Roth 401(k), you may want to review the following points before making your decision:

- Although future tax rates are difficult to predict, you may benefit from a Roth 401(k) or 403(b) if you anticipate being in a higher tax bracket during retirement.

- Even if your marginal tax rate remains relatively stable, you may face a higher tax bill in retirement if you will no longer claim deductions for mortgage interest and other types of deductions frequently used by families. If this sounds like a likely scenario, a Roth 401(k) may be to your advantage.
- Will you need your retirement assets for living expenses during your later years? If not, a Roth 401(k) offers the opportunity to roll over funds directly to a Roth IRA, which does not require distributions by the owner after he or she turns 70½. This situation may enhance the potential tax-free growth of your assets and enable you to bequeath a potentially larger portion of your assets to your heirs.
- For 2018, eligibility to contribute to a Roth IRA begins to phase out for single taxpayers with modified adjusted gross income (MAGI) of $120,000 and married couples filing jointly with MAGI of $189,000. A Roth 401(k) may have some appeal if your eligibility to contribute to a Roth IRA is affected by these thresholds.
- The longer you remain invested in a Roth 401(k), the more you are likely to benefit from tax-free growth. If you plan to retire in five years or less, a shorter term time horizon may limit the benefit of tax-free withdrawals, whereas your account may get a bigger boost from tax-free savings if you plan to continue working for a longer period of time.

Capitalizing on every option available to you may make it easier to pursue your long-term savings goal. If tax-free withdrawals could potentially benefit you, and your employer makes a Roth 401(k) available, consider adding it to your retirement planning mix.

## Comparison With Roth IRAs

The tax treatment of the Roth 401(k) plan is basically the same as that of the Roth IRA. Both accept contributions made with after-tax dollars, and both allow tax-free withdrawals beginning at age 59½, provided contributions began at least five tax years earlier.

But there are significant differences to consider. Some aspects of the Roth 401(k) plan are more generous, and some are less generous than those available in a Roth IRA. For example, unlike a Roth IRA, the Roth 401(k) plan has no income restrictions. As a result, the Roth 401(k) may be attractive to higher paid employees who have been unable to contribute to a Roth IRA. And the annual contribution limit for the Roth 401(k) is much higher than that for the Roth IRA ($5,500 for 2018 plus $1,000 catch-up contribution for individuals aged 50 and older).

On the other hand, the Roth 401(k) has one drawback compared with the Roth IRA among people who do not want to be required to take money out of their account. Unlike the Roth IRA, which has no minimum distribution requirements during your lifetime, minimum distributions from a Roth 401(k) generally must begin in the year after the participant turns age 70½. However, the assets in a Roth 401(k) can be rolled into a Roth IRA if the employee retires or leaves the company, which would allow the account holder to circumvent this requirement.

## Planning Pointers

Given the rules, the Roth 401(k) could potentially be appealing to workers who expect to be in a higher tax bracket after retirement or who have many years to continue saving before retirement. It may also be of interest to higher paid workers who have been precluded from contributing to the Roth IRA because of income restrictions. The Roth option may not be as attractive to someone nearing retirement and expecting to need to tap his or her nest egg soon.

Without doubt, there's much to weigh in determining whether a Roth 401(k) may be right in your situation, and you may welcome the advice of a trusted financial professional as you assess this option in relation to your retirement plan.