AdvisorEdge

Roth 401(k) Plan

What is a Roth 401(k) Plan?

The Roth 401(k) combines some of the most advantageous aspects of both the 401(k) and the Roth IRA. Under the Roth 401(k), employees can decide to contribute funds on a post-tax elective deferral basis, in addition to, or in-stead of, pre-tax elective deferrals under their traditional 401(k) plans. An employee's combined elective deferrals-- whether to a traditional 401(k), a Roth 401(k), or to both-- cannot exceed the IRS limits for deferral of the traditional 401(k).
Employer's matching funds are not included in the elective deferral cap but are considered for the maximum section 415 limit, which is $57,000 for 2020.

Employers are permitted to make matching contributions on employees' designated Roth contributions. However, employers' contributions cannot re-ceive the Roth tax treatment. The matching contributions made on account of designated Roth contributions must be allocated to a pre-tax account, just as matching contributions are on traditional, pre-tax elective contributions.

In general, the difference between a Roth 401(k) and a traditional 401(k) is that income contributed to the Roth version is taxable in the year it is earned, while income contributed to the traditional version is taxable in the year it is distributed from the account. Furthermore, earnings on the traditional version are taxable income in the year they are distributed, while earnings on the Roth version are not taxable ever.

There are restrictions on the non-taxability of Roth earnings: typically, the distribution must be made at least 5 years after the first Roth contribution and after the recipient is age 59½.

A Roth 401(k) plan will probably be most advantageous to those who might otherwise choose a Roth IRA, for example, younger workers who are currently taxed in a lower tax bracket, but expect to be taxed in a higher bracket upon reaching retirement age. Higher-income workers who wish to save the maximum amount allowed may favor the Roth 401(k) because it effectively allows greater real contributions, as post-tax dollars are more valuable than pre-tax dollars; however, those near the Roth IRA income limits may prefer a tradition-al 401(k), since its pre-tax contributions lowers Modified Adjusted Gross In-come (MAGI) and thus increases eligibility for Roth IRA contributions. Another consideration for those currently in higher tax brackets is the future of income tax rates in the U.S. (if income tax rates increase, current taxation would be desirable for a wider group).

2020 Roth IRA Eligibility: Income

Single filers full contribution	up to $124,000
Partial contributions	$124,000 - $139,000
Joint filers full contribution	up to $196,000
Partial contribution	$196,000 - $206,000

The Roth 401(k) offers ...

the advantage of tax free distribution, but is not constrained by the same income limitations. For example, in tax year 2020, normal Roth IRA contributions are limited to $6,000 ($7,000 if age 50 or older); whereas, up to $19,500 could be contributed to a Roth 401(k) account, provided no other elective deferrals were taken for the tax year (no traditional 401(k) deferrals taken). Catch-up contribution: Individuals age 50 or older (in the calendar year of their contribution) or 100% of employment compensation can contribute an additional $1,000 each year.

Additional Considerations

- Roth 401(k) contributions are irrevocable, such that once money is invested into a Roth 401(k) account; it cannot be moved to a regular 401(k) account.
- Employees can roll their Roth 401(k) contributions over to a Roth IRA account upon termination of employment.
- Unlike Roth IRAs, owners of Roth 401(k) ac counts (designated Roth accounts) must begin distributions at age 70 and a half, as with IRA and other retirement plans.