

The Roth 401(k): An Introduction

Key Points

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Employees who enroll in a Roth 401(k) plan will set aside money from their paychecks after it has been taxed, but the money can then grow on a tax-deferred basis and contributions and earnings can eventually be withdrawn tax free. It's this particular tax treatment that distinguishes the Roth 401(k) plan from the traditional 401(k) plan. In a traditional 401(k) plan, contributions are made on a pre-tax basis and can grow tax deferred until withdrawn, when contributions and earnings are taxed at the individual's ordinary income tax rate.

Authorized by 2001 Federal Tax Law

The Roth 401(k) was waiting in the wings since 2001, when it was authorized by the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). But the law delayed its introduction until 2006, when it was made permanent.

The Roth 401(k) has features that may be attractive to you, depending on your current income tax rate, future income expectations, the number of years you have to save, and what you estimate your tax rate will be in retirement.

How the Roth 401(k) Works

A look at the rules governing Roth 401(k) plans may help you decide whether they would work to your advantage.

- A Roth 401(k) plan participant may contribute up to \$16,500 in 2011. An additional \$5,500 in catch-up contributions is allowed if you are age 50 or older. If you are also contributing to a traditional 401(k) plan, the maximum you can contribute to both accounts for 2011 is \$16,500 (plus \$5,500 if you meet the age requirement).
- Should you decide to make both Roth and traditional 401(k) plan contributions, you'll effectively have two separate accounts. The assets have to be kept separate because of the unique tax treatment of each plan type. For the same reason, you can't switch your Roth 401(k) plan savings over to a traditional 401(k) plan later on.
- If your employer provides matching contributions, you can earn a match when you contribute to your Roth 401(k) plan account, but the matching portion cannot be directed into the Roth account. Instead, the matching portion would be directed to your traditional 401(k) plan account.
- You can withdraw money from the Roth 401(k) without paying tax or penalties provided you are at least age 59½ and have held the account for five years or longer. These are the same rules that apply to Roth IRAs.
- Just as with a traditional 401(k), you will need to begin taking minimum distributions (RMDs) after you reach age 70½.
- You can roll over your Roth 401(k) plan assets to a Roth IRA when you retire or change employers. Assets in a traditional 401(k) may now be rolled into either a traditional IRA or Roth IRA. With a rollover from a traditional to a Roth, however, taxes on the pre-tax portion will apply. In addition, Roth 401(k) plan assets can be rolled into another employer's Roth 401(k) plan, if available and plan rules allow.

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 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 new Roth 401(k) is much higher than the Roth IRA (\$5,000 for 2011 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, 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 eliminate 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.

Points to Remember

1. The Roth 401(k) allows you to make after-tax contributions in exchange for the right to withdraw the money tax free during retirement.
2. Tax- and penalty-free withdrawals may begin at age 59½ provided the account is at least five years old. Minimum distributions must begin after turning age 70½.¹
3. You can roll over Roth 401(k) assets to a Roth IRA when you retire or terminate employment.
4. There are some similarities and some significant differences between Roth 401(k) plans and Roth IRAs.
5. In choosing between a Roth and traditional 401(k) plan, you may want to take into account how much time you have until retirement and your tax situation, among other factors.

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