Choosing Between Traditional and Roth 401(k)s

Traditional and Roth 401(k) plans both provide tax-advantaged ways to save for retirement. Which works best for you will depend upon your unique circumstances.

Many workers now have -- or may soon have -- a new retirement planning option to consider: the Roth 401(k), which permits participants to save for retirement on an after-tax basis. In return for forgoing a tax deduction at the time of contribution, participants may make withdrawals free of taxes and penalties if they are age 59½ or older and have maintained the account for five years or more. This feature may appeal to investors who anticipate being in a higher tax bracket in retirement.

Contribution limits for the 2013 tax year are identical to those for a traditional 401(k): an annual maximum of $17,500, plus an additional "catch up" contribution of $5,500 for workers aged 50 or older. Once contributions are made to a Roth 401(k), they cannot be transferred to a traditional 401(k), and assets in a traditional 401(k) cannot be transferred to a Roth 401(k).

The Roth 401(k) may appeal to workers willing to forego 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.

Like a traditional 401(k), workers enjoy the convenience of contributing through payroll deduction. But similar to 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 years. There is also a Roth 403(b) plan for workers in the nonprofit sector.

How a Roth 401(k) Works

The Roth 401(k) follows many of the same rules as a traditional 401(k). For the 2013 tax year, federal laws permit a maximum annual contribution of $17,500, 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 are made in pre-tax dollars. If you are age 50 or older, you may contribute an additional $5,500 for a total of $23,000 in 2013.

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 and funds in a traditional 401(k) cannot be switched to a Roth 401(k). Both Roth and traditional 401(k)s require distributions after age 70½, but only if you are no longer working. If you continue to work beyond age 70½, you will not be required to take distributions from either type of account. However, distributions must begin when you finally do leave the workforce.

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	Pre-tax 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 years.
Rollovers to IRAs	May be rolled over directly to a traditional or 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 dependents, mortgage interest, and other types of deductions frequently utilized 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 after age 70½. This situation may enhance the potential tax-free growth of your assets and enable you to bequeath a larger portion of your assets to your heirs.
- While individuals at any income level may contribute to a traditional IRA, the deductibility of contributions may be limited, depending if they participate in a qualified employer-sponsored retirement plan. Roth IRAs are limited to single taxpayers with income under $127,000 and married couples with income under $188,000 in 2013. A Roth 401(k) may have some appeal if you desire tax-free withdrawals but your income exceeds the threshold for a Roth IRA.
- 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.

Points to Remember

1. A Roth 401(k) offers the option of investing for retirement on an after-tax basis. In return for foregoing a tax deduction when the contribution is made, participants may be able to make withdrawals free of penalties and income taxes during retirement.
2. Workers may elect to make all or a portion of their 401(k) contribution to a Roth 401(k). Once made, however, a contribution cannot be transferred to a traditional 401(k) and assets in a traditional 401(k) cannot be switched to a Roth 401(k).
3. The annual maximum contribution for 2013 is the same as for a traditional 401(k): $17,500 plus an additional $5,500 catch-up contribution for employees aged 50 and older.
4. Employers who provide a matching contribution are required to allocate the match to a traditional 401(k), not a Roth account.
5. Either Roth or traditional 401(k) balances may be rolled directly over to an IRA or another eligible retirement plan, although taxes may apply and the rollover rules can be complex. See your financial advisor prior to requesting a rollover.