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A monthly savings tip from the American Savings Education Council (ASEC)—October 2013

To Roth or Not?

A growing number of retirement plan participants are finding a new option on their plan menu; the Roth 401(k). And it's an option that can apply to 403(b) (nonprofit) and 457(b) (public-sector) retirement plans as well.

In one key respect, the Roth 401(k) works just the opposite of your 401(k): You pay taxes on the money you defer into the Roth 401(k) BEFORE it is contributed, while the taxes on your regular pre-tax 401(k) contributions are not paid until AFTER they are withdrawn. When you withdraw the Roth 401(k) contributions, you don't pay taxes on them—because you've already paid those taxes.

However, with a Roth 401(k), you also can withdraw earnings on those contributions without paying taxes on them, so long as the distribution is made at least five years after the first Roth contribution and you reach age 59-½, unless an exception applies (the earnings on your regular 401(k) contributions are taxed when you withdraw them, regardless of how long the contributions have been in the plan).

Will a Roth 401(k) Work for You?
While every situation is unique, experts suggest that a Roth 401(k) works best for workers who expect their tax rate to be higher in the future, since, with the Roth option, you are paying taxes now rather than deferring them into the future as with a regular 401(k). This should make the Roth 401(k) option particularly attractive for younger workers, as well as workers who expect tax rates overall to be higher in the future than they are today, particularly higher-income workers.

In addition to that 401(k), you may already have a Roth IRA. So, what's a **Roth 401(k)?** As the name suggests, it is really a combination of the two savings options.

It is like a Roth IRA in that:
- Your contributions are made on an after-tax basis, and earnings on those contributions accumulate on a tax-free basis.
- Withdrawals taken during retirement are not subject to income tax, so long as you are at least age 59-½, and have had the account for five years or more.

It is different from a Roth IRA in that:
- There are no compensation limits imposed for eligibility.
- You may defer more to a Roth 401(k) than you can to a Roth IRA.
- Your Roth 401(k) is subject to required minimum distribution (RM) rules, while a Roth IRA is not.

It is like a regular 401(k) in that:
- Your contributions may be matched by your employer.
- Your contributions—Roth 401(k) and regular 401(k) combined—are subject to the current 401(k) deferral limits ($17,500 in 2013). Additionally, catch-up contributions of up to $5,500 for those 50 or older by the end of the year are permitted.
- The rules for withdrawals are the same.

It is different from a regular 401(k) in that:
- The contributions are made on an after-tax basis (after income taxes are withheld).
- Earnings accumulate on a tax-free basis, rather than tax-deferred (subject to withdrawal limits).

For more information, see the Internal Revenue Service (IRS) Retirement Plans FAQs on Designated Roth Accounts