Consider a Roth 401(k) plan — and make sure employees use it

Roth 401(k) accounts have been around for 13 years now. Studies show that more employers are offering them each year. A recent study by the Plan Sponsor Council of America (PSCA) found that Roth 401(k)s are now available at 70% of employer plans, up from 55.6% of plans in 2016.

However, despite the prevalence of employers offering Roth 401(k)s, most employees aren't choosing to contribute to them. The PSCA found that only 20% of participants who have access to a Roth 401(k) made contributions to one in 2017. Perhaps it's because they don't understand them.

If you offer a Roth 401(k) or you're considering one, educate your employees about the accounts to boost participation.

A 401(k) with a twist

As the name implies, these plans are a hybrid — taking some characteristics from Roth IRAs and some from employer-sponsored 401(k)s.

An employer with a 401(k), 403(b) or governmental 457(b) plan can offer designated Roth 401(k) accounts.

As with traditional 401(k)s, eligible employees can elect to defer part of their salaries to Roth 401(k)s, subject to annual limits. The employer may choose to provide matching contributions. For 2019, a participating employee can contribute up to $19,000 ($25,000 if he or she is age 50 or older) to a Roth 401(k). The most you can contribute to a Roth IRA for 2019 is $6,000 ($7,000 for those age 50 or older).

Note: The ability to contribute to a Roth IRA is phased out for upper-income taxpayers, but there's no such restriction for a Roth 401(k).

The pros and cons

Unlike with traditional 401(k)s, contributions to employees' accounts are made with after-tax dollars, instead of pretax dollars. Therefore, employees forfeit a key 401(k) tax benefit. On the plus side, after an initial period of five years, "qualified distributions" are 100% exempt from federal income tax, just like qualified distributions from a Roth IRA. In contrast, regular 401(k) distributions are taxed at ordinary-income rates, which are currently up to 37%.

In general, qualified distributions are those:

- Made after a participant reaches age 59½, or
- Made due to death or disability.

Therefore, you can take qualified Roth 401(k) distributions in retirement after age 59½ and pay no tax, as opposed to the hefty tax bill that may be due from traditional 401(k) payouts. And unlike traditional 401(k)s, which currently require retirees to begin taking required minimum distributions after age 70½, Roth 401(k)s have no mandate to take withdrawals.

Not for everyone

A Roth 401(k) is more beneficial than a traditional 401(k) for some participants, but not all. For example, it may be valuable for employees who expect to be in higher federal and state tax brackets in retirement. Contact us if you have questions about adding a Roth 401(k) to your benefits lineup.