

What Is a Roth 401(k)?

The arena of employer-sponsored retirement plans has been dominated by 401(k) plans that are funded with pre-tax contributions, which effectively defers taxes until distributions begin. However, the recently created Roth 401(k) is funded with after-tax money just like a Roth IRA, allowing retirees to enjoy qualified tax-free distributions once they reach age 59½ and have met the five-year holding requirement.

It might be smart to invest in a Roth 401(k) if you believe that you will be in a higher tax bracket during retirement. This is always a possibility, especially if you end up with fewer tax deductions during your post-working years. On the other hand, if you expect to be in a lower tax bracket during retirement, then deferring taxes by investing in a traditional 401(k) may be the answer for you. If you have not been able to contribute to a Roth IRA because of the income restrictions, you will be happy to know that there are no income limits with a Roth 401(k).

Employers may match employee contributions to a Roth 401(k) plan, but any matching contributions must go into a traditional 401(k) account. Therefore, employers must have both types of plans in place if they want to offer their workers a Roth 401(k).

If an employer offers a Roth 401(k) plan, the employees will usually have the option of contributing to either the regular or the Roth 401(k), or even both at the same time. If you do not know which type of account would be better for your financial situation, you might want to split your contributions between the two types of plans. It's important to note that your combined annual contributions to a 401(k) plan cannot exceed \$18,000 if you are under age 50, or \$24,000 if you are 50 or older (in 2015). These amounts are indexed annually for inflation.

If your employer offers a Roth 401(k) plan and it allows in-plan Roth conversions, you can make transfers to a Roth 401(k) account at any time. Conversion is a taxable event. Funds converted are taxed as ordinary income.

Upon separation of service, workers can roll over their Roth 401(k) assets to another Roth 401(k), a Roth 403(b), or a Roth IRA. Assets cannot be rolled over to a traditional 401(k) plan. If you transition from an employer that offers a Roth 401(k) plan to an employer that does not, your only option would be to roll the assets directly to a Roth IRA or to leave your money in your former employer's plan (if allowed).

The required minimum distribution guidelines of a Roth 401(k) work like those of traditional 401(k) plans. You must begin taking distributions after reaching age 70½, either as a lump sum or on a required minimum distribution schedule based on your life expectancy. However, unlike a traditional 401(k), Roth distributions would be free of federal income taxes.

If you see the advantages of having tax-free income in retirement, then you might want to consider a Roth 401(k). It allows you to contribute more annually than you could to an IRA, and the tax-free distributions won't add to your income tax liability. Of course, before taking any specific action, you might want to consult with your tax professional.

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