Roth 401(k)s

The Thompson Wealth Management website provides access to a useful calculator to compare Traditional 401(k) with Roth 401(k) contributions.

When you participate in a traditional 401(k) plan, the taxable salary that your employer reports to the IRS is reduced by the amount that you defer to your account. This means income taxes on that money are postponed until you withdraw from your account, usually after you retire.

An increasing number of employers are offering employees a relatively new 401(k) choice—a Roth 401(k). If you participate in a Roth 401(k), the amount you defer doesn't reduce your taxable income or your current income taxes. But when you withdraw after you retire, the amounts you take out are tax-free, provided you're at least 59½ and your account has been open at least five years.

Both the traditional 401(k) and Roth 401(k) offer tax advantages when you defer a portion of your salary into an account in your employer's retirement savings plan. Both feature tax-deferred compounding of contributions that are made to the account. Both have no income limits and require minimum distributions after you turn 70½ in most cases, and both can be rolled over to an IRA when you retire or leave your job for any reason.

Here is a chart showing the different tax structures for the two 401(k) options:

Contributions	Come from pre-tax income, reducing gross income reported to IRS	Come from taxable income, not reducing gross income reported to IRS
Withdrawals	Taxed at your ordinary income tax rate	Tax-free provided account is open at least five years and you are at least 59½

Employers may offer a Roth 401(k) only if they already offer a traditional 401(k)—and may give you the option of splitting your annual contribution between a traditional and Roth 401(k)—though your total contribution can't be more than the annual limit Congress sets for a 401(k). However, once you've made contributions, you may not move money between the two 401(k) accounts because of their different tax structures.

What's more, if your modified adjusted gross income is too large to allow you to qualify for a Roth IRA, a Roth 401(k) is one way to have access to tax-free withdrawals. There are no income restrictions limiting who can participate. The only requirement is being eligible to participate in your employer's plan.

Which is right for you?

There is no one-size-fits-all answer. Instead, the right answer for you will depend on your current tax situation and whether your tax rate is likely to be higher or lower in retirement.

Since you don't pay any taxes on Roth withdrawals, the higher your tax bracket in retirement, the more advantageous a Roth is likely to be. Strong savers—including those who contribute the maximum amount allowed by the IRS each year—are good Roth candidates because they are likely to have a bigger nest egg in retirement that can benefit from Roth's tax-free withdrawals.

On the other hand, if you're in a low tax bracket today, you might consider a Roth now, when a lowering of your gross income will not be as significant a tax benefit as it might be later on, if you find yourself in a higher bracket.

Because it comes right out of your paycheck, a Roth contribution is likely to reduce your take home pay by more than a similar contribution to a traditional 401(k), which is made using pre-tax dollars. If you want to save—and take home as much money as possible—a traditional 401(k) is perhaps the way to go.

The good news is that it is often possible to contribute to both a traditional and a Roth 401(k). Since no one knows what tax rates will be in the future, diversifying with contributions to both a traditional 401(k) and Roth might be a way to hedge your tax bets with your retirement savings.

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