Roth 401(k) Basics

What is the difference between a regular 401(k) deferral (pre-tax) and a Roth 401(k) deferral?

Under either a regular 401(k) deferral or a Roth 401(k) deferral, you make a deferral contribution by electing to set aside part of your pay (by either a certain percentage or a certain dollar amount). For a regular 401(k) deferral, the taxable wages on your W-2 are reduced by the deferral contribution; therefore, you pay less current income tax. However, you will eventually pay tax on these contributions and earnings when the plan distributes the regular 401(k) deferrals and earnings to you. The result is that the tax on the regular 401(k) deferrals and earnings is only postponed.

A Roth 401(k) deferral is an after-tax contribution, which means you must pay current income tax on the deferral. Since you have already paid tax on the deferral, you won't pay tax on it again when you receive a distribution of your Roth 401(k) deferral. In addition, if you satisfy certain distribution conditions, you won't have to pay tax on the earnings either. This means that the distribution of the Roth 401(k) earnings can be tax-free, not just tax-deferred.

How do I make a Roth 401(k) deferral contribution?

You make a Roth 401(k) deferral contribution the same way that you make a regular 401(k) deferral contribution (i.e., from your pay via payroll withholding). You elect to contribute a certain percentage or dollar amount of your pay. When you elect how much you want to contribute, you must also specify whether the contribution is either a Roth 401(k) deferral or a regular 401(k) deferral.

Is there a limit on how much I may defer?

For 2022, the Roth 401(k) deferral limit is $20,500 ($26,500 if you are allowed to make catch-up contributions), the same limit as the regular 401(k) deferral limit. However, if you make both regular 401(k) deferrals and Roth 401(k) deferrals in the same calendar year, a single limit applies to the sum of both types of deferrals.

How do I get a tax-free distribution of Roth 401(k) earnings?

If the distribution of your Roth 401(k) deferral account is made when you are at least age 59 1/2, or upon your death or disability, then you may be entitled to a tax-free distribution of earnings. However, you must also satisfy the "5-year participation requirement." The "5-year participation requirement" is satisfied once you have had funds in your Roth 401(k) account for five years. However, you do not have to make Roth 401(k) deferrals in each of the five years.

If a distribution from my Roth 401(k) deferral account does not meet the conditions for tax free treatment, what are my income tax consequences?

If a distribution from your Roth 401(k) deferral account does not satisfy the conditions to be tax-free, then you will pay income tax on your distributed Roth 401(k) earnings, but you won't be taxed again on the distributed Roth 401(k) deferrals. You may avoid the tax on the Roth 401(k) earnings by rolling over (i.e., transferring) the Roth 401(k) deferral account to a Roth 401(k) or other retirement plan that includes Roth deferral provisions.

May I roll over my Roth 401(k) deferral account?

Yes. If you are entitled to a distribution from the plan, then you may roll over your Roth 401(k) deferral account, but only to a Roth IRA or to a 401(k) plan or 403(b) plan that permits Roth deferrals. You may not roll your Roth 401(k) deferral account to a regular IRA or to any other plan.

What factors should I consider in deciding whether to make a Roth 401(k) deferral or a regular 401(k) deferral?

Your decision to make Roth 401(k) deferrals or regular 401(k) deferrals involves a number of factors that are discussed below. In general, the longer Roth 401(k) deferrals remain in the plan, the more favorable they are (i.e., the Roth deferrals may result in more tax savings than regular 401(k) deferrals). The factors to consider when deciding whether to make Roth 401(k) deferrals or regular 401(k) deferrals depends upon many unknown items. Because of this, it is sometimes suggested that you consider making both regular deferrals and Roth 401(k) deferrals.

Ability to afford higher contributions

One of the most important items to think about is whether your decision to contribute regular 401(k) deferrals or Roth 401(k) deferrals will affect the amount of salary deferrals that you can afford to contribute to the plan. If you can afford to contribute the same dollar amount of salary deferrals, regardless of whether they are regular 401(k) deferrals or Roth 401(k) deferrals, then that means you should think more about making Roth 401(k) deferrals. Your ability to afford higher contributions becomes more important in two situations: (1) When a plan provides for a matching contribution, or (2) when you want to contribute the maximum amount allowed by the plan or by the law. In the case of matching contributions, it is to your benefit to contribute the maximum amount that will be matched under the plan. If you are not able to contribute enough Roth 401(k) deferrals to receive the maximum matching contribution, then you maybe better off making a larger contribution with regular 401(k) deferrals.

Current and future tax rates

Another item to think about is your federal income tax rate at the time of the contribution, compared to your expected tax rate at the time you would receive a distribution. Regular 401(k) deferrals are taxed when distributed. Roth 401(k) deferrals are taxed when these are made to the plan. If you believe that your tax rate will be lower in the future when you receive distributions from the plan, then you should consider making regular 401(k) deferrals to the plan. If you believe that your tax rate will be higher when you receive distributions from the plan, then you should consider making Roth 401(k) deferrals.

When the deferrals will be withdrawn

You should also think about when you will want, or need, to withdraw the contributions from your account. If you think you will withdraw your contributions before you satisfy the “5-year participation requirement,” then you may be better off making regular 401(k) deferrals. Another factor is whether you will accumulate funds in a retirement plan for as long as possible. You must begin receiving distributions from the plan by the later of your retirement or your attainment of age 70 1/2. For estate planning purposes, you may want to delay the receipt of distributions beyond your retirement or your attainment of 70 1/2. You can delay the distribution of Roth 401(k) deferrals if you rollover the Roth 401(k) deferrals and earnings to a Roth IRA.