Is a Roth or Traditional 401(k) Right for You?

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The traditional 401(k) has been around a while. Now the new kid on the block, the Roth 401(k), is the current darling of the investment world.

Both are employer-sponsored investment savings accounts and are good ways to save for retirement. The big difference involves whether contributions are made using pre- or post-tax money, and thus whether the distributions you take in retirement are taxable or tax-free.

It's important to understand the differences between a Roth vs. traditional 401(k).

The Basics: Roth vs. Traditional 401(k)s

In a traditional 401(k), the money you contribute comes out of your paycheck *before* you pay taxes on it. Doing this reduces your overall current taxable income by the amount you contribute, and the contributions and earnings grow tax-deferred. You pay taxes on the money once you start taking distributions in retirement.

Money you contribute to a Roth 401(k) comes out *after* taxes, so you have already paid taxes on it when you begin taking distributions. It's tax-free income at that point, and the thinking behind it is you might be in a lower tax bracket now than you will be when you retire.

Both types of plans have contribution limits based on age. For 2019, the annual limit is $19,000, and those over 50 can put in an additional $6,000. Those limits increase by $500 in 2020. Anyone at any income level can participate in both types of 401(k)s.

The Roth 401(k) is different from a Roth IRA, which has smaller contribution limits and a maximum income limit impacting who can participate. An IRA is not tied to your employer — it's your account alone.

More and more companies are now offering a Roth 401(k) in addition to a traditional 401(k). A 2017 survey of 349 large and mid-sized American companies by Willis Towers Watson found about 70% of companies now have Roth features in their 401(k) plans, up from 54% in 2014 and 46% in 2012.

"It's essentially giving anybody the opportunity to pay some tax, which they normally do, but then put money in an account that's never, ever taxed again for the rest of their lives," said Andrew Barnett, a certified financial planner with GFA Wealth Design based in Fort Myers, Florida. "There's no other thing like that in this country, in the tax code. There's absolutely nothing like it. It's an amazing thing. Think about investing and never paying taxes again, forever."

You don't have to pick just one type of 401(k) to invest in. As long as you don't go over the total contribution limit, you can split your contributions between the two types of accounts.

Investing in a Roth 401(k)

Roth 401(k)s are attractive to people who think their tax bracket will be higher when they retire than it is now.

Primarily, these people are early in their career, like millennials born between 1979 and 2000. A 2018 survey of 5,100 workers and 1,8000 employers by The Harris Poll for the 19th Annual Transamerica Retirement Survey found millennials are the most likely to contribute to a Roth 401(k) if it is available. Baby Boomers contribute at a rate of 30%, Generation X at 42%, and millennials at 52%.

"They're going to be paying taxes now in a low tax bracket and that money has the chance to grow for the rest of their lives and into their kids' lives, if they want it to, without ever paying taxes again," Barnett explained.

If your employer offers a Roth 401(k) option, your contributions go into it after taxes, but any employer match must go into a pre-tax account. You will eventually have to pay taxes on that company match, but not on the earnings from that money.

Paying the taxes when you contribute also eliminates uncertainty about changing tax laws in the future.

The plan handles all of the bookkeeping, so the investor doesn't have to do anything to keep it all straight.

As with traditional 401(k) accounts, the owner is eligible to take distributions beginning at age 59½ and must take distributions at age 70½. It is also possible to roll the money from a Roth 401(k) into a Roth IRA, eliminating the required minimum distributions.

But there is one caveat. In order to take a distribution from a Roth 401(k) at age 59½ or any other age, the account must have been open for at least five years.

Because of that five-year rule, a Roth 401(k) is not an attractive option for people who are close to retirement and will need to access the money within five years or who expect to be in a lower tax bracket in retirement.

"If you're going to be needing the money any time soon, [the Roth 401(k)] is a bad idea because you're going to get a penalty," Barnett said.

Rolling a Traditional 401(k) into a Roth

If you currently have a traditional 401(k) and want to roll over your money into a Roth 401(k), you can do so but you will pay taxes when you do it since that money has not been taxed yet.

Barnett has a warning about conversions since money moving from a traditional 401(k) into a Roth 401(k) is taxed as income at your current tax rate: "If you're considering doing conversions, you have to be really careful, because what if you're in a low tax bracket right now and if you did a conversion, it would throw you into a higher tax bracket?" he said. "So you would want to manage that conversion, meaning you don't do it all in one year."

	Roth 401(k)	Traditional 401(k)

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Money comes directly from paycheck	Yes	Yes
Contribution limits	Yes	Yes
Taxation	Money goes in after tax	Money goes in before tax
Company match	Yes, but pre-tax	Yes
Contributions reduce gross taxable income	No	Yes
Distributions are tax-free	Yes	No
Age for withdrawals	59½ (but account must have been open for 5 years)	59½
Required Minimum Distributions	Age 70½ (unless still working for the company)	Age 70½ (unless still working for the company)

Deciding Which Type of 401(k) is Best For You

Since it is impossible to predict your future tax bracket, it isn't always easy to know which is right for you, a Roth vs. traditional 401(k).

Take a look at your current cash flow. Contributing to a Roth 401(k) hits your budget harder because you are paying taxes on your whole income and then making the contribution. If you need more cash now, deferring the taxes until you begin taking distributions might work best for you.

But if you're the type who would rather miss the money a bit now and have more later, a Roth 401(k) would allow you to later receive exactly the amount you take out, stretching the nest egg even further.

"Let's say there's a million dollars in there when you're ready to take it out. In a regular 401(k) you are going to be writing checks for $250,000. But with a Roth 401(k), you're never going to be writing a tax check," Barnett said. "So if you had two buckets of money, one was taxable and one was not taxable, the non-taxable one is going to last longer."

Remember, it doesn't have to be all or nothing. You can divide your contributions between both types of accounts, as long as you don't contribute more than the maximum.

For most people, Barnett says the Roth 401(k) makes sense.

"There's no other tax opportunity out there that gives you those advantages," he said. "It has given savers a way to pay taxes once when they're in a low tax bracket. I can't stress the impact of what that means over a long period of time. Interest is never taxed, dividends are never taxed, capital gains are never taxed. It's an absolute no-brainer."

Tiffani Sherman is a Florida-based freelance reporter with more than 25 years of experience writing about a variety of topics, including finance, health and travel. She likes to save money so she can travel more.