Abstract: While 401(k) plans and Roth IRAs are well known, job candidates and employees may not be all that familiar with the Roth 401(k). This article discusses what business owners should know about this potentially valuable employee retirement benefit.

Benefit with a twist: The Roth 401(k)

Most everyone has heard of a 401(k) plan, and a sizable number of adults likely have at least a passing familiarity with the Roth IRA. What remains less well known among job candidates and employees is the Roth 401(k) plan. This retirement benefit with a twist might be worth offering to your staff, so long as you and they understand how it works.

Hybrid plan

As the name implies, Roth 401(k)s are hybrid plans that take some characteristics from employer-sponsored 401(k)s and others from Roth IRAs. Any employer with an existing 401(k), 403(b) or governmental 457(b) plan can offer designated Roth 401(k) accounts.

From there, 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 2020, a participating employee can contribute up to $19,500 ($26,000 if he or she is age 50 or older) to a Roth 401(k). The most you can contribute to a Roth IRA for 2020 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).

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%.

Generally, qualified distributions are those made after a participant reaches age 59½ or because of a 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. Roth 401(k)s follow the same required minimum distribution rules as traditional 401(k)s, but employees can avoid mandated withdrawals by converting a Roth 401(k) to a Roth IRA.

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 than in their working years. Contact us if you have questions about adding a Roth 401(k) to your benefits lineup.