Roth 401(K), Worth a Fresh Look?

This year marks the 20th anniversary of the Roth Individual Retirement Account (IRA). While the Roth IRA has been widely hailed as a powerful retirement saving vehicle because of its tax-free-growth and has seen widespread adoption by individuals who meet the income requirements, the Roth 401(k) isn't nearly as popular.

That status, however, may change. The recent tax reform law poses an opportunity for employers to take another look at the Roth 401(k). While the new law doesn't include significant changes for 401(k)s, lower marginal income tax rates may make the Roth 401(k) option slightly more attractive to participants and may spur more plan sponsors to add Roth plans to their benefit offerings.

Before jumping in, however, it is important to determine whether adding the Roth feature is beneficial to your workforce. Analyzing areas like participation rates and age of workforce are important considerations, but it's also important to see whether there might be additional administrative costs or other issues impacting the overall benefits package as a result of the addition. If Roth is a good option, it's critical to effectively communicate the differences and the reasons a Roth 401(k)—and the tax-free growth that it offers—might be something for participants to consider.

Roth 401(k) Basics

As the name implies, the Roth 401(k) blends features of the Roth IRA with the traditional 401(k) plan. Accounts are set up similar to traditional 401(k)s, but like the Roth IRA, the Roth 401(k) allows participants to contribute after-tax dollars. In terms of tax benefits, the Roth 401(k) flips the structure of the traditional 401(k): money is taxed (based on an individual's income tax bracket) going into the plan, and any qualified withdrawals, including the growth of the investment, are tax-free. Employers are allowed to make contributions on behalf of employees, but by law, those dollars must be deposited into a traditional 401(k) account.

The Roth 401(k) was established in 2001, but most plan sponsors waited to offer it until 2006 when the Pension Protection Act made the new savings vehicle permanent. In 2006, only 18.4 percent of companies offered a Roth 401(k), according to The Plan Sponsor Council of America (PSCA).

While Roth 401(k) adoption has grown dramatically since then, it still significantly trails the traditional 401(k) in terms of popularity. Only 63 percent of plans offered a Roth 401(k) option in 2016, according to PSCA's 60thAnnual Survey of Profit Sharing and 401(k) Plans. Compare that to the 94 percent of companies surveyed using a traditional 401(k). What's more, most participants aren't taking advantage of the Roth's tax-free growth benefits; only 18 percent of participants eligible for the Roth strategy made contributions in 2016, the PSCA survey found.

There are several reasons behind Roth's slow growth. First, it's a relatively more difficult strategy for plan sponsors to explain to their participants. Second, participants who have been automatically deferred to a traditional 401(k) account tend to stay put. Finally, one of the major factors in determining whether it's more beneficial to contribute to a traditional or Roth 401(k) is whether the participant's tax rate during retirement will be higher or lower than the participant's current tax rate—a difficult prediction to make with any certainty.

Many participants may have overlooked the Roth 401(k) as a retirement savings option because they aren't eligible to contribute to a Roth IRA due to fairly restrictive income limits. But it's important for plan sponsors to point out that income limits don't apply to Roth 401(k)s, so all participants, regardless of income, can participate.

The IRS has created a table that provides a full comparison of the rules related to contribution limits, income limits, taxation of withdrawals and withdrawal requirements for the Roth 401(k), Roth IRA and traditional pre-tax 401(k).

Roth Could Now Be More Beneficial, But Understanding Costs and Communicating Benefits Are Critical

For plan sponsors that are considering adding the Roth option to their retirement plans, it's important to remember the following:

- Roth plans typically entail additional administrative and payroll requirements, so you will want to work with your service providers to understand these potential issues
- Analyzing the demographic and financial makeup of your workforce is an important part of determining whether adding a Roth option makes sense
- Employees often struggle to understand the differences between Roth and traditional 401(k) plans, so effective communication is essential

In terms of the last point, the tax-free growth benefits of Roth 401(k)s have become a bit more attractive compared to the upfront tax benefits of traditional 401(k)s because many Americans are now positioned in lower tax brackets. It's also important to keep in mind that future legislative action could raise rates.

The Roth benefits are particularly compelling for younger workers, who 1) typically have lower incomes as they start their careers and 2) have more time until retirement to benefit from the Roth's tax-free growth and withdrawal structure.

When it comes to communicating these benefits to employees, it can be helpful to illustrate the difference between the two 401(k) strategies by using a hypothetical scenario, such as:

- Jack is a 25-year-old employee who contributes $15,000 a year to a Roth 401(k) until retiring at age 65; he is currently in the 22 percent tax bracket and expects to be in the 32 percent tax bracket in retirement; he expects to earn a rate of return of 7 percent on his investments
- Jill is also 25-years-old, is in the same tax brackets, and expects to earn the same rate of return until retiring at age 65; but rather than contributing $15,000 a year to a Roth 401(k), she contributes the same amount to a traditional 401(k) and invests the rest in a taxable account

Under these assumptions, the after-tax value of Jack's Roth 401(k) would be $3.1 million at retirement, whereas the after-tax value of Jill's traditional 401(k) would be $2.6 million. Even if Jack and Jill assume that they will be in the same tax bracket during retirement as they are now (22%), the Roth option is still worth more than $200,000 more than the traditional option.

It's especially important to show these types of examples to employees who are automatically enrolled in the traditional 401(k) plan. Often, these participants set their contribution schedule and don't think about it again. But these participants may reconsider if shown the difference in after-tax benefits using actual dollar amounts, rather than abstract financial concepts.

In light of the new tax laws, now could be a good time for plan sponsors to consider adding a Roth component to 401(k) offerings. An effective communication strategy is key in demonstrating to participants the impact a Roth 401(k) can make on saving for retirement. Roth's benefits, however, need to be considered in light of the potential costs and administrative requirements for plan sponsors and their service providers.