Understanding the Roth 401(k)

As the name suggests, a Roth 401(k) combines features of the traditional 401(k) with those of the Roth IRA. It's offered by employers like a regular 401(k) plan, but as with a Roth IRA, contributions are made with after-tax dollars. While you don't get an upfront tax-deduction, the account grows tax-free, and withdrawals taken during retirement aren't subject to income tax, provided you're at least 59 1/2 and you've held the account for five years or more.

The Roth 401(k) can offer advantages to high-income individuals who haven't been able to contribute to a Roth IRA because of the income restrictions. (Eligibility for 2013 phases out between $112,000 and $127,000 for single filers and $173,000 to $183,000 for those who are married and file jointly). There are no such income restrictions for Roth 401(k)s.

In addition, Roth 401(k) accounts are subject to the contribution limits of regular 401(k)s -- $17,000 for 2013, or $23,000 for those 50 or older by the end of the year -- allowing individuals to stock away thousands of dollars more in tax-free retirement income than they would through a Roth IRA. (In 2013, Roth IRA contributions are limited to $5,500 a year, or $6,500 for those 50 or older.)

The hitch: Those limits apply to contributions to all types of 401(k) plans, so you can't save $17,500 in a regular 401(k) and another $17,500 in a Roth 401(k). There's no new opportunity to save here, but there's an opportunity to save with a different kind of tax treatment.

Workers who are offered this option face a difficult choice: Contribute to a Roth 401(k) and suffer a cut in take-home pay (since contributions are made with after-tax dollars), or stick with a traditional 401(k) and hope that in retirement, their tax rate will be lower than it is now. Alternatively, they could hedge their bets by contributing to both accounts.

If you expect your tax rate to be the same or higher in retirement than it is now, you might be better off with a Roth 401(k). This is likely to be the case with young people who are just starting their careers and expect their income to increase in the future. For those who are in the 15% or 25% tax bracket, it may not be a bad idea to pay those taxes now and never have to worry about what tax brackets might become in the future. If you're in your peak earning years, on the other hand, and you figure your tax bracket will be lower in retirement, you'll benefit from continuing with traditional 401(k) contributions.

In reality, of course, things are much more complicated. For one, no one can predict with certainty what tax rates will be in the future, though the general consensus is that they're likely to rise to help the government offset growing budget deficits and pay for Social Security and Medicare. That's one reason why people in the top tax brackets have indicated their preference for the Roth 401(k). They are ready to pay the regular tax now, whatever it is, because the certainty that they won't have to pay taxes in the future offsets the value of the tax deferral.

Still have questions about the Roth 401(k)? We thought so. And we've gone ahead and answered the most important ones.

1. Who is eligible for a Roth 401(k)?
Anyone whose employer offers it. This is where it gets tricky: Among the major concerns for employers are the costs associated with managing the plan, and educating their workforce about this investment option. According to the PSCA's Wray, companies are much more likely to offer a Roth 401(k) if their employees indicate that they intend to participate. So if you want a Roth 401(k) option to be added to your plan, make sure to let your employer know.

2. What happens to the employer match?
Employer matches are made with pretax dollars, and the match accumulates in a separate account that is taxed as ordinary income at withdrawal.

3. What are the early withdrawal rules?
Early Roth 401(k) withdrawal rules are subject to the same requirements as traditional 401(k)s, according to the IRS. However, those regulations aren't set in stone. If your company rolls out a Roth 401(k) next year, be sure to ask your plan manager.

4. What happens if I leave my job?
The Roth 401(k) balance can be rolled over into a Roth IRA.

5. Is the Roth 401(k) option here to stay?
Yes. At one time, the Roth 401(k) option was set to expire after 2011, but it was made permanent by 2006 legislation. So this is a deal you can count on.