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Why Adding a Roth 401(k) Option Could Boost Employee Savings

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A decade after they first became available, Roth 401(k) plans are now offered by many employers. Employees are also getting on board — particularly the younger ones — even without fully understanding how they work, a Harvard study suggests.

Roth 401(k) vs. Roth IRA vs. traditional 401(k)

Roth 401(k) plans operate on the same principle as their older cousin, the Roth IRA: Participants make contributions on an after-tax basis, but qualified distributions are tax-free. (Any employer-matching contributions, however, are pretax and must flow into a separate account.)

Roth 401(k)s have an advantage over Roth IRAs for highly paid employees: Participation eligibility isn't capped by income. The only cap is the annual 402(g) limit imposed by the IRS for employee deferrals.

An advantage of a Roth 401(k) over a standard 401(k) is that participants can avoid required minimum distributions (RMDs) after age 70½ by rolling their Roth balance into a Roth IRA. This allows those dollars to accumulate tax-free indefinitely, and be passed on to heirs, if participants choose.

Can participants borrow money from their Roth IRA? The short answer: Not really. Like many employer-sponsored retirement plans like 401(k) plans that allow participant loans, there's no such thing as an "IRA loan."

Finally, in the opposite scenario (a participant wants to access funds sooner), the Roth 401(k) has another advantage over a traditional 401(k): Before age 59½, Roth 401(k) participants can tap into principal amounts contributed to their account (but not investment returns) without a 10% early withdrawal penalty. They must, however, have been in the plan for at least five years to take advantage of that opportunity.

Employee participation

Roth 401(k)s make more sense financially for some employees than others; offering employees both kinds of 401(k)s leaves it up to them to decide which is better. T. Rowe Price, for example, reports that 61% of employers in its client database offered a Roth option in 2016 — a 10% jump from 2015. According to T. Rowe Price's data, the percentage of 401(k) participants with access to Roth 401(k)s who then made contributions to a Roth 401(k) was about 6% in 2016, down from 7% in 2015. However, this drop may be explained by the 10% increase in availability of the Roth option from 2015; many employees haven't had a chance to warm up to the new option yet.

More detailed research from Alight Solutions, a consulting firm, indicates that, when the participation rate data is sliced by age bracket among employees who have access to a Roth 401(k) plan, the numbers are more impressive. For example, it found that in 2016 close to 20% of employees in the 20 to 29 age bracket who have the option to take advantage of the Roth option do so. Participation rates drop for each successive older age bracket, down to around 11% for employees in the 40 to 59 age range, and 7% for the 60-plus cohort.

That pattern suggests that some participants could be following general advice offered with respect to who is best suited to take advantage of a Roth. According to conventional wisdom, younger employees are in lower tax brackets because they tend to earn less than older participants. That means that the opportunity cost of missing out on making their 401(k) contributions on a pretax basis is lower than it would be for someone in a higher tax bracket.

For example, it would cost a single-filer employee with a federal marginal tax rate of 15% only $750 in forgone federal income tax savings to contribute $5,000 to a Roth 401(k), and nearly twice that amount ($1,400) for a single filer in the 28% tax bracket.

Employee knowledge

But are employees performing this kind of analysis? The conclusion of a recent study by Harvard University researchers suggests that perhaps they aren't, which in turn also suggests that Roth 401(k)s are a particularly good option to put in front of employees.

According to the Harvard study, when participants switched to a Roth 401(k), they maintained the same deferral rates they had been using with the conventional 401(k) plan. If the employees who made that switch had analyzed the implications of doing so, they would have realized that, by making their 401(k) deferrals on an after-tax basis, they could afford to reduce their deferrals, and wind up at retirement with the same amount of money. How? Because those funds wouldn't be reduced by taxes when they took their distributions in retirement.

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“Our survey experiment provides suggestive evidence that employee confusion about and neglect of the tax properties of Roth balances … prevent contribution rates from falling following a Roth introduction,” the study concludes. The upshot is that “the total amount of retirement consumption being purchased via the 401(k) increases after the Roth is made available.”

Smart saving

Adding a Roth option to your 401(k) may help your employees to effectively save more than they otherwise would have. That’s a win for everyone.

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