Traditional & Roth 401(k) Plan

What is a 401(k) Plan?

A 401(k) plan is a tax-advantaged, defined-contribution retirement account offered by many employers to their employees. It is named after a section of the U.S. Internal Revenue Code. Workers can make contributions to their 401(k) accounts through automatic payroll withholding, and their employers can match some or all of those contributions. The investment earnings in a traditional 401(k) plan are not taxed until the employee withdraws that money, typically after retirement. In a Roth 401(k) plan, withdrawals can be tax-free.[1]

Plan Highlights

- A 401(k) plan is a company-sponsored retirement account that employees can contribute to. Employers may also make matching contributions.
- There are two basic types of 401(k)s—traditional and Roth—which differ primarily in how they're taxed.
- In a traditional 401(k), employee contributions reduce their income taxes for the year they are made, but their withdrawals are taxed. With a Roth, employees make contributions with post-tax income but can make withdrawals tax-free.

How 401(k) Plans Work

There are two basic types of 401(k) accounts: traditional 401(k)s and Roth 401(k)s, sometimes referred to as a "designated Roth account." The two are similar in many respects, but they are taxed in different ways. A worker can have either type of account or both types.

Contributing to a 401(k) Plan

A 401(k) is what's known as a defined-contribution plan. The employee and employer can make contributions to the account, up to the dollar limits set by the Internal Revenue Service (IRS). By contrast, traditional pensions [not to be confused with traditional 401(k)s] are referred to as defined-benefit plans—the employer is responsible for providing a specific amount of money to the employee upon retirement.[2]

In recent decades, 401(k) plans have become more plentiful, and traditional pensions increasingly rare, as employers have shifted the responsibility and risk of saving for retirement to their employees.

Employees are also responsible for choosing the specific investments within their 401(k) accounts, from the selection their employer offers. Those offerings typically include an assortment of stock and bond mutual funds as well as target-date funds that hold a mixture of stocks and bonds appropriate in terms of risk for when that person expects to retire. They may also include guaranteed investment contracts (GICs) issued by insurance companies and sometimes the employer's own stock.

Contribution Limits

The maximum amount that an employee or employer can contribute to a 401(k) plan is adjusted periodically to account for inflation. In 2021, the basic limits on employee contributions are $19,500 per year for workers under age 50 and $26,000 for those 50 and up (including the $6,500 catch-up contribution).[3]

If the employer also contributes—or if the employee elects to make additional, non-deductible after-tax contributions to their traditional 401(k) account (if allowed by their plan)—the total employee/employer contribution for workers under 50 for 2021 is capped at $58,000, or 100% of employee compensation, whichever is lower. For those 50 and over, again for 2021, the limit is $64,500.[4]

Employer Matching

Employers who match their employee contributions use different formulas to calculate that match. A common example might be 50 cents or $1 for every dollar the employee contributes up to a certain percentage of salary. Financial advisors often recommend that employees try to contribute at least enough money to their 401(k) plans each to get the full employer match.

Contributing to a Traditional and Roth 401(k)

If they wish—and if their employer offers both choices—employees can split their contributions, putting some money into a traditional 401(k) and some into a Roth 401(k). However, their total contribution to the two types of accounts can't exceed the limit for one account.

Taking Withdrawals from a 401(k)

Participants should remember that once their money is in a 401(k), it may be hard to withdraw without penalty.

The earnings in a 401(k) account are tax-deferred in the case of traditional 401(k)s and tax-free in the case of Roths. When the owner of a traditional 401(k) makes withdrawals, that money (which has never been taxed) will be taxed as ordinary income. Roth account owners (who have already paid income tax on the money they contributed to the plan) will owe no tax on their withdrawals, as long as they satisfy certain requirements.[5]

Both traditional and Roth 401(k) owners must be at least age 59½—or meet other criteria spelled out by the IRS, such as being totally and permanently disabled—when they start to make withdrawals. Otherwise, they usually will face an additional 10% early-distribution penalty tax on top of any other tax they owe.[6]

Required Minimum Distributions

Both types of accounts are also subject to required minimum distributions, or RMDs. (Withdrawals are often referred to as "distributions" in IRS parlance.) After age 72, account owners must withdraw at least a specified percentage from their 401(k) plans, using IRS tables based on their life expectancy at the time (prior to 2020, the RMD age had been 70½ years old).

If they are still working and the account is with their current employer, however, they may not have to take RMDs from that plan.[7]

Note that distributions from a traditional 401(k) are taxable. Qualified withdrawals from a Roth 401(k) are not, but they do lose the tax-free growth of being within the 401(k) account.

Traditional 401(k) vs. Roth 401(k)

When 401(k) plans first became available in 1978, companies and their employees had just one choice: the traditional 401(k). Then, in 2006, Roth 401(k)s arrived. Roths are named for former U.S. Senator William Roth of Delaware, the primary sponsor of the 1997 legislation that made the Roth IRA possible.[8]

While Roth 401(k)s were a little slow to catch on, many employers now offer them. So the first decision employees often have to make is between Roth and traditional.

As a general rule, employees who expect to be in a lower marginal tax bracket after they retire might want to opt for a traditional 401(k) and take advantage of the immediate tax break. On the other hand, employees who expect to be in a higher bracket might opt for the Roth so that they can avoid taxes later. For example, a Roth might be the right choice for a younger worker whose salary is relatively low now but likely to rise substantially over time.

Also important—especially if the Roth has years to grow—is that there is no tax on withdrawals, which means that all the money the contributions earn over decades of being in the account is also not taxed.

Since no one can predict what tax rates will be decades from now, neither type of 401(k) is a sure thing. For that reason many financial advisors suggest that people hedge their bets, putting some of their money into each.

1. Internal Revenue Service. "401(k) Plan Overview." Accessed Mar. 11, 2021.
2. Internal Revenue Service. "Definitions." Accessed Feb.17, 2021.
3. Internal Revenue Service. "Retirement Topics - 401(k) and Profit-Sharing Plan Contribution Limits." Accessed Feb.17, 2021.
4. Internal Revenue Service. "2021 Limitations Adjusted as Provided in Section 415(d), etc." Accessed Feb. 17, 2021.
5. Internal Revenue Service. "Roth Comparison Chart." Accessed Feb. 17, 2021.
6. Internal Revenue Service. "Retirement Topics - Exceptions to Tax on Early Distributions." Accessed Feb. 17, 2021.
7. Internal Revenue Service. "Retirement Plan and IRA Required Minimum Distributions FAQs." Accessed Feb. 17, 2021.
8. Internal Revenue Service. "Roth IRAs." Accessed Feb. 17, 2021.

Content sourced from www.investopedia.com

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