Younger People Taking Advantage of Roth 401ks

by [Sheryl Nance-Nash]

Roth 401ks are increasingly popular with young people. In a recent Wells Fargo survey, in the first quarter of this year, nearly 17% of participants under age 30 contributed to a Roth 401k, up from 15.2% a year ago, as compared to 4% of participants in their 60s. In addition, overall, the number of people with access to a Roth 401k increased by 5.3%.

Roth 401ks have been around since 2006 and people now seem to be checking them out, especially younger people. If however, Roth 401ks are a bit of a mystery to you, here are a few things to get you started on your path to understanding.

What can a Roth 401k do for you?

There are several reasons to get excited about a Roth 401k. One of the main advantages is that there is no income limitation in order to participate. Participants are able to contribute as much as $17,500 in 2013 and an additional $5,500 in "catch-up" provisions for those who are age 50 or older. Most employers also provide a matching contribution to the employee's contribution, which average 3% across many industries, says Abigail Gunderson, a certified financial planner with Tanglewood Wealth Management.

Another big plus is that qualified distributions are tax-free. This means earnings are allowed to accumulate over the years free of regular income or capital gains taxes, thus providing more retirement income.

Although a Roth 401k requires that distributions begin no later than age 70 ½, similar to traditional 401ks, a Roth 401k could be rolled into a Roth IRA. What's the advantage of doing that? "There is no requirement of a Roth IRA to start making distributions at any age. If the owner has other sources of income, these funds can continue to accumulate potentially tax-free throughout the person's lifetime. This can serve as an effective estate planning tool, as well, since the assets can grow for many years during a person's retirement and eventually be passed on to his or her heirs," explains Gunderson.

Roth 401k ideal for young people

The question though, is why are young people in particular going for Roth 401ks? The Roth 401k makes a great deal of sense for younger investors primarily because of the power of compounding. “Having assets grow for 20-30 years without any taxes along the way or upon distribution is an extremely powerful tool,” says Brad Bofford, managing partner at Financial Principles.

Additionally, he says, one can argue that there is a higher likelihood that the investor will be in a higher tax bracket later in their career, so it's okay to forgo the tax deduction today at a lower rate. Then too, he says, there is a general consensus that tax rates will continue to rise overall, so one is hedging by paying taxes at a lower rate on a lesser amount of money today.

“Younger employees have a long runway for investing, so the tax benefit can be quite substantial,” says Laurie Nordquist, director of Wells Fargo Institutional Retirement and Trust.

Advantages for older workers too

While young people in particular have much to gain from a Roth 401k, others can benefit too.

“Both younger and older investors may benefit from a Roth 401k, it really depends on what the older investors' goals are for retirement and their heirs, and what they believe may happen to their tax bracket later in life. Some retirees may be faced with higher taxes in retirement than while they were working, given the complexity of the tax system, so it really depends on several factors,” says Jerry Korabik, a financial advisor with Savant Capital Management.

Know the facts

Like always, there are some myths or misconceptions. “Sometimes employees think that if they put money into a Roth 401k account they might not get an available matching contribution from the employer. The matching formula is usually based on how much money you put into the plan, not which 'bucket' you put the money into,” says Joseph Creal, a financial consultant with Cambridge Consulting group.

You also need to be careful when you transfer Roth 401k money out from a plan if you leave your employer. “You may need to roll money into proper IRA buckets to avoid a tax nightmare,” says Creal.

Know too, that in order to qualify for tax-free withdrawals, the account must be funded for at least five years and the distribution must be for one of the following – disability, separation from service, death or attainment of age 59 ½, says Bob Gavlak, a wealth advisor with Strategic Wealth Partners.

Mostly though says Leonard Wright, CPA and co-host of the radio show, Financial Fridays, “New entrants to the work force need to save in a Roth 401k – there's tax free growth with little tax sacrifice.”