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Commentary

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How Americans use Roth contributions in DC plans

Key takeaways

- Roth savings provide tax diversification and can bring additional benefits for many participants as they prepare for retirement.
- 80% of plans now offer a Roth option, and 17% of participants contribute to Roth accounts, up from 11% in 2018.
- Recently, the SECURE 2.0 Act of 2022 was passed into law, and several provisions impacted Roth 401(k) savings.

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Introduction

Roth 401(k) plans have many potential advantages for participants, including tax diversification, Social Security, and estate planning benefits.

Despite their many perks, however, most participants fail to take advantage of Roth contributions.

The recent passage of the SECURE 2.0 Act expands the use of Roth contributions in defined contribution plans. The information that follows provides an overview of Roth contributions, a summary of the new Roth provisions from the recent legislation, plan design considerations, and targeted communication strategies for plan sponsors to strengthen the financial well-being of their employees.

The basics of Roth 401(k) plans

Plan sponsors began offering Roth 401(k) options to their employees in 2006. In contrast to traditional 401(k) plans, in which participants make contributions on a pre-tax basis and don't pay taxes until they make withdrawals, the Roth 401(k) allows participants to pay taxes on their retirement savings contributions up front and avoid taxes on their withdrawals in retirement.

All withdrawals of Roth savings are free from federal income tax in retirement if the participant is at least 59½ years old and their account has been open for at least five years. Participants in plans that offer the Roth option in addition to a traditional option can choose to make their contributions on a pre-tax basis, a Roth basis, or some combination of the two.

Contributing to a Roth 401(k) can provide an important benefit known as "tax diversification." Just as investors hedge the risks of stocks by holding bonds, participants can hedge the risk of uncertain future tax rates by making both Roth and pre-tax contributions. In addition, the Roth 401(k) can increase the effective value of retirement savings by allowing participants to pre-pay taxes that would otherwise eat into retirement income. Plus, Roth 401(k)s can provide spending flexibility, easier tax reporting, and certain estate planning benefits.

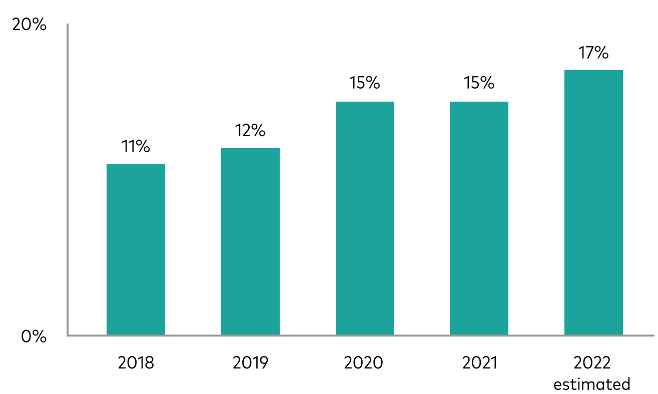
Plan adoption and participant usage

A recent Vanguard publication, *How America Saves 2023*, revealed that 80% of plans offered Roth options as of December 2022. Among participants who had access to Roth accounts, 17% contributed to them, up from 11% in 2018 (**Figure 1**).

FIGURE 1.

Percentage of participants using Roth (when offered)

Vanguard defined contribution plans that offer Roth contributions



Source: Vanguard 2023.

Larger plans were more likely to offer Roth accounts. In fact, 94% of plans with 5,000 or more participants permitted Roth contributions, compared to just 71% of plans with fewer than 500 participants (**Figure 2**). All told, 93% of participants had access to Roth accounts.

FIGURE 2.

Percentage of participants using Roth (when offered)

Vanguard defined contribution plans that offer Roth contributions

Percentage of plans offering Roth	2018	2019	2020	2021	2022
<500	61%	65%	65%	68%	71%
500–999	78%	78%	81%	80%	84%
1,000–4,999	81%	83%	82%	86%	88%
5000+	87%	88%	88%	91%	94%
All plans	71%	74%	74%	77%	80%

Source: Vanguard 2023.

One notable finding from the report was that younger and higher-income participants tend to use Roth accounts more frequently than older and lower-income participants (**Figure 3**). What accounts for this disparity? Younger employees are typically in lower tax brackets and may prefer paying taxes now rather than several years later when their income may be taxed at a higher rate. Meanwhile, higher-income employees may opt for Roth contributions now because they can afford to pay the current taxes in exchange for the ability to save more in their 401(k) plan on an after-tax basis.

5% of participants contributed solely to Roth accounts in 2022.

FIGURE 3.

Roth participation rates by participant demographics, 2022 estimated

Vanguard defined contribution plans that offer Roth contributions

Percentage of participants using if offered	77%
Income	
<$15,000	8%
$15,000–$29,999	9%
$30,000–$49,999	10%
$50,000–$74,999	16%
$75,000–$99,999	21%
$100,000–$149,999	22%
$150,000+	18%
Age	
<25	18%
25–34	22%
35–44	18%
45–54	15%
55–64	13%
65+	8%

Source: Vanguard 2023.

That said, most participants with access to Roth accounts do not take advantage of them. Just 5% of participants in plans that offer Roth contributions contributed solely to Roth accounts in 2022, while an additional 12% contributed to both traditional and Roth accounts (**Figure 4**). Participants who chose to save in Roth accounts tended to have higher savings rates—perhaps partly because higher-income participants were more likely to use Roth contributions.

FIGURE 4.

Percentage of participants using Roth (when offered)

Vanguard defined contribution plans that offer Roth contributions

	Participants using traditional pre-tax only	Participants using Roth only	Participants using traditional pre-tax and Roth
Percentage of participants	83%	5%	12%
Average actual employee savings rate	6.6%	7.9%	9.7%

Source: Vanguard 2023.

The benefits of Roth contributions

Having a sizable Roth balance in retirement can provide strong tax diversification and lower overall tax liability by reducing the need to draw down from taxable accounts (i.e., traditional 401(k) plans and IRAs). Here are four scenarios in which Roth contributions could be beneficial:

A sizable purchase in retirement using accumulated savings.

Taking a substantial withdrawal from a taxable vehicle could put a taxpayer in a higher tax bracket. Withdrawing from a Roth account, on the other hand, would not impact their tax liability, allowing them to make a large purchase without worrying about negative tax implications.

Collecting Social Security benefits.

Withdrawals from Roth accounts are not only potentially tax free, they also have no negative impact on the taxation of Social Security benefits. In fact, relying less on taxable IRA and 401(k) withdrawals reduces the percentage of Social Security income that is taxed.

Estate planning

Historically, Roth IRAs have not been subject to required minimum distribution (RMD) rules. Beginning in 2024, under the SECURE 2.0 Act, Roth 401(k)s will also not be subject to RMD rules. As long as inherited Roth accounts have been open for at least five years, withdrawals will be tax-free. This change may be especially helpful to a beneficiary currently subject to the "10-year rule," which requires the beneficiary to liquidate the account by the end of the 10th year following the year of death of the account owner, as taxes limited to a 10-year period could potentially erode the value of an inheritance.

Fully prepared for retirement

Historical maximum savers who are expecting a high replacement income in retirement will likely remain in the same tax bracket in retirement. Holding substantial pre-tax balances would increase exposure to potential tax increases, including taxes on Social Security income.

Despite the many benefits of Roth contributions, there may be circumstances where traditional pre-tax contributions are preferable for some participants. Participants whose income and tax rate are both likely to be reduced in retirement or who have temporarily high income may prefer traditional pre-tax accounts. In addition, families that stand to qualify for earned income and/or additional tax credits may want the lower taxable income amounts that come with traditional pre-tax accounts.

The Mega Roth feature

One increasingly popular strategy that leverages Roth contributions is the "Mega Roth" option. This strategy can be used by high-income earners who reach the annual 402(g) limit and would prefer to save more in their retirement plan. By contributing after-tax dollars above the 402(g) limit, participants can have those contributions automatically converted to Roth savings, with minimal or no additional taxes.

Without taking advantage of the Mega Roth option, high-earning participants may only be able to save about 7% of their eligible pay. The Mega Roth option allows participants to save up to the 415(c) annual additions limit ($66,000 in 2023), which includes both employee and employer contributions. A highly paid participant would be able to save about 16% of their pay. Add that to a typical 4% employer contribution, and the combined savings comes out to about 20%, nearly twice as much as under normal circumstances.

Targeted communications can improve usage rates

Once the Roth option has been added to a plan, sponsors should consider how to educate participants about the benefits of Roth contributions. Given the tax intricacies of Roth accounts, some participants find them difficult to fully comprehend. Because of this, a targeted, long-term approach to communication often works best.

For example, targeted emails can provide important information about Roth contributions, educating participants about the benefits of tax diversification. Webinars and informational articles can reinforce the message of the benefits of Roth accounts. A robust education strategy helps give participants the best chance for a comfortable retirement.

SECURE 2.0

Recently, the SECURE 2.0 Act of 2022 was passed into law. The Act is designed to increase employees' ability to save for retirement. Several provisions in the law impact Roth 401(k) savings.

Catch-up contributions – Beginning in 2024, participants who wish to make catch-up contributions to their retirement accounts and a) made more than $145,000 (indexed) in the previous year, b) are over 50 years of age, and c) exceed the regulatory deferral limit will be required to make those contributions on a Roth basis. (For those making under $145,000, Roth is not required but remains an option for catch-up contributions).

Employer contributions – Beginning immediately, retirement plans may offer a Roth option for an employer match or nonelective contribution, as long as those contributions are fully vested.

Required minimum distributions (RMDs) – Beginning in 2024, participants with Roth accounts are no longer subject to pre-death RMDs.

Vanguard suggests

Plan sponsors who currently do not offer Roth options should consider adding them to accommodate current and future regulations, which will allow participants to save up to the maximum regulatory limits with the benefit of tax diversification.

Final thoughts

Most of the benefits that existed in 2006 when Roth contributions were first introduced are still available to plan participants today. The tax diversification that Roth accounts offer has the potential to help participants at any age and income level, and recent legislation will create additional opportunities for retirement savers in the years to come.

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All investing is subject to risk, including the possible loss of the money you invest

Withdrawals from a Roth IRA or a Roth 401(k) are tax free if you are over age 59½ and have held the account for at least five years; withdrawals taken prior to age 59½ or five years may be subject to ordinary income tax or a 10% federal penalty tax, or both. (A separate five-year period applies for each conversion and begins on the first day of the year in which the conversion contribution is made).

We recommend that you consult a tax or financial advisor about your individual situation.

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