

Traditional vs. Roth Employer Retirement Accounts



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Introduction

Employee retirement contribution plans such as 401(k), 403(b), and 457 have been in use for over 40 years and have become the predominant retirement savings vehicles for U.S. employees. The name of each plan refers to the section within the federal tax code for the Internal Revenue Service (IRS) which sets the laws of administration. With many employers providing such plans and offering matching contributions to their employees, employees should prioritize taking advantage of these plans and funding such matching plans when saving for retirement.

With the introduction of Roth employer plans in 2006, this added option has created confusion for many employees as they wonder which account (Traditional or Roth) is best for their situation. It is not necessarily an either-or decision. Further, regardless of how employees direct their contributions, any contributions made by the employer will be directed to a Traditional account. Both Traditional and Roth accounts have merit and are viable savings vehicles for retirement.

The right course will come down to the employee's individual situation and will be influenced by current cash flow needs, current income tax rates, and the employee's projected income tax rate during retirement. Generally speaking, Traditional accounts are a preferred option for those looking to reduce current income tax burdens. Roth accounts tend to be more favorable to employees wanting greater financial flexibility in retirement and those who are concerned with reducing retirement tax burdens.

Traditional Accounts

Traditional accounts began with the Revenue Act of 1978, which created Section 401(k) of the Internal Revenue Code. They can be thought of as pretax retirement accounts because they allow an employee to put direct wages in an account without having to pay income taxes on the contribution. In other words, employees receive an immediate reduction in their taxable income since they are electing to defer receipt until a future date. For example, if someone earns \$103,500 and contributes \$23,500 to a Traditional 401(k) account, that employee's taxable income for the year would be \$80,000 and they would move into a lower income tax bracket (based on 2025 federal income tax brackets for all filing statuses). Traditional accounts grow tax deferred and distributions are treated as income when withdrawn.

An advantage of using a Traditional account for retirement savings is that, as just described, the contribution can reduce the employee's tax liability in the year it is made. With less paid in taxes, more dollars can be invested, and all funds in a Traditional account grow without any tax implications until a distribution is taken from the account. In the event an employee ends up in a lower tax bracket at retirement than during their working years, distributions would be taxed at an income tax rate lower than the tax rate avoided at the point of contribution.

Drawbacks to any retirement savings plan established by the IRS are the penalties that generally apply for pulling funds out prior to the account holder reaching the age of 59 1/2, unless the distribution qualifies for specific exceptions established by the IRS as outlined in the following link (<https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions>).

For Traditional accounts, the IRS imposes Required Minimum Distribution (RMD) rules, which mandate distributions at the point the account holder reaches a certain age (currently set at age 73). The RMD amount is based on a percentage of the prior year-end value of Traditional accounts. The divisor applied to the year-end balance is set by the IRS's "Uniform Lifetime Table" ([link to table](#)). RMDs have the potential of forcing distributions and taxable income onto account holders who would otherwise elect to defer such events. It should be noted that there is also a 50% penalty on the amount of the RMD that is not withdrawn in any given calendar year. For example, if an investor's RMD is calculated to be \$20,000 and they only take \$15,000, they will then owe a \$2,500 penalty to the IRS (50% of \$5,000), plus income tax on the \$5,000 not withdrawn.

Roth Accounts

The Roth 401(k) was added as an option that employers could provide to their employees starting January 1, 2006. Roth accounts are often referred to as post-tax retirement accounts because funds that go into a Roth account do not reduce taxable income and are taxed in the year they are earned/contributed. Since contributions are taxed at the front end, Roth account distributions are not taxed when withdrawn. This highlights one of the main advantages of a Roth account, which is that growth and subsequent distributions are tax-free. Many who utilize a Roth account like the idea of being able to withdraw funds from their account without needing to factor in tax consequences. Since employer retirement accounts can be rolled over to an Individual Retirement Account (IRA), another benefit is that Roth funds that are rolled over to a Roth IRA are not subject to RMDs. This allows the individual the option to leave assets in the Roth IRA throughout their lifetime and pass the account to their spouse, children, or other beneficiaries income tax-free.

The potential disadvantage of Roth accounts is that account contributions don't reduce the amount of income reported for taxes. Higher taxes mean reduced cash flow. As an example, let's assume the employee wants \$10,000 contributed from their wages into a retirement account, and they are currently in the 32% marginal tax bracket. With \$10,000 directed to a Traditional account, this would reduce the income tax obligation to the IRS by \$3,200. Thus, the employee only realized a net cash flow reduction of \$6,800. The same \$10,000 contribution to a Roth account would not provide

the income tax reduction, meaning the employee's cash flow is reduced by the full \$10,000.

Contribution Limits

Some employers offer to match their employees' contributions to the workplace retirement plan. For example, an employer may match 50% of employee contributions up to 6% of employee salary. Upon learning about the matching contribution, some employees then incorrectly believe 6% is the maximum they can contribute to their plan, when, in fact, contribution limits for workplace retirement plans are set by the federal government. In 2025, the maximum an employee can contribute to a 401(k), 403(b), or 457 plan is \$23,500. Employers can also add to an employee's retirement account through profit-sharing contributions, either in addition to or instead of matching contributions. The contributions from the employer, when combined with contributions from the employee, cannot exceed 100% of the employee's compensation or \$70,000 (whichever is less) in 2025. However, an employee aged 50 or older is allowed to contribute an additional \$7,500, known as a catch-up contribution, and employees aged 60-63 are allowed a larger catch-up contribution of \$11,250.

As mentioned earlier, employer contributions to a workplace plan go into the Traditional account regardless of the account the employee contributes to. Thus, an employee contributing to a Roth 401(k) would receive a matching contribution from their employer and would then have funds in both the Roth and Traditional sections of their 401(k) account.

Summary

An employer retirement plan in which the employer matches contributions is a benefit that all employees are strongly encouraged to utilize. Choosing between Traditional and Roth account contributions, though, should be based on the employee's individual financial situation. As mentioned above, electing Roth contributions and having both Traditional and Roth accounts will provide greater options on where to draw funds at retirement to maintain your lifestyle and control taxes. You should make the Traditional versus Roth account decision based on the facts of your current situation and reevaluate every couple of years to see if the decision continues to make sense or requires adjustments.