Do We Really Want Roth Retirement Plans to Be More Generous Than Traditional Plans?

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MarketWatch Blog by Alicia H. Munnell

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Eliminating required minimum distributions makes Roth 401(k)s much more valuable.

Something snuck by me. The SECURE 2.0 Act eliminated required minimum distributions (RMDs) for Roth 401(k)s. At first glance, that change seems relatively harmless. After all, the account holders paid taxes up front, so why force them to withdraw their money. What that rationale ignores is that the assets in the Roth continue to generate tax-free returns, even after the account holder reaches 73 – the age when RMDs kick in for traditional plans. That ability to continue to save tax free makes Roths considerably more valuable.

A quick refresher on the so-called equivalence between traditional and Roth plans may be a good way to clarify what has happened. Under a traditional 401(k) plan, the government does not tax the original contribution nor the returns on those contributions until the funds are withdrawn from the plan. In contrast, initial contributions to Roths are not tax deductible, but interest earnings accrue tax free and no tax is paid when the money is withdrawn.

Although the traditional and Roth plans may sound quite different, the conventional argument is that they offer virtually identical tax benefits. Unfortunately, the easiest way to demonstrate this point is with equations. Assume that t is the individual's marginal tax rate and r is the annual return on the assets in the plan. If an individual contributes $1,000 to a traditional plan, then after n years, the balance would have grown to $\$1,000\ (1+r)^n$. When the individual withdraws the accumulated funds, both the original contribution and the accumulated earnings are taxable. Thus, the after-tax value in retirement is $(1-t)\ \$1,000\ (1+r)^n$.

Now consider a Roth. The individual pays tax on the original contribution, so he puts $(1-t)$ $1000 into the account. After n years, these after-tax proceeds would have grown to $(1+r)^n\ (1-t)\ \$1,000$. Since the proceeds are not subject to any further tax, the after-tax amounts under the Roth and traditional plans are identical:

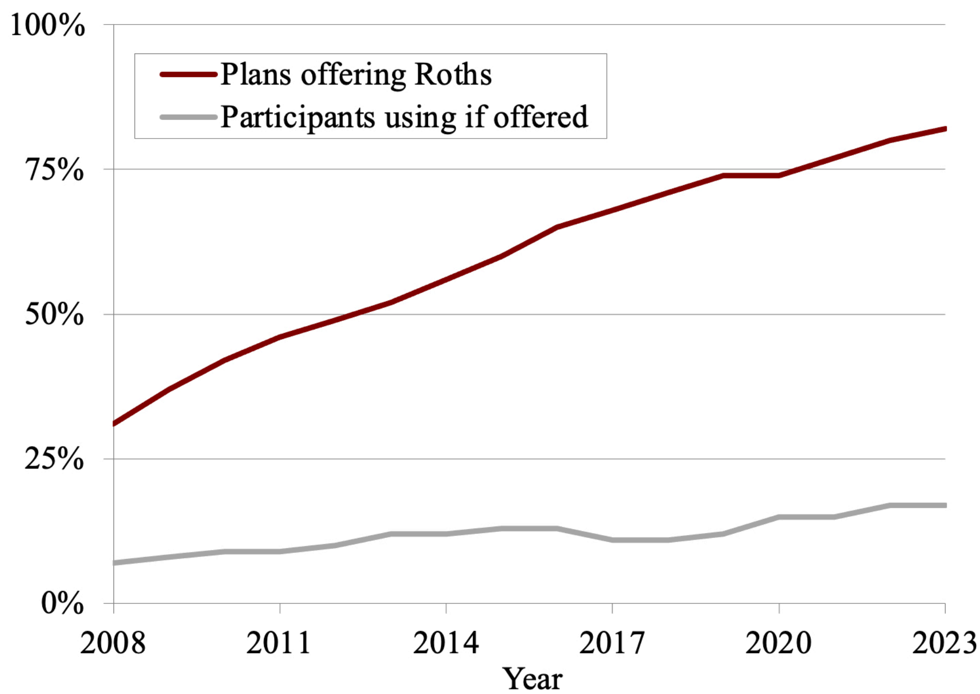
$$\underset{\textbf{Roth}}{(1+r)^n\ (1-t)\ \$1,000} = \underset{\textbf{Traditional}}{(1-t)\ \$1,000\ (1+r)^n}$$

Note that a key assumption in this exercise is that n – the number of years of accumulation – is the same in both cases. That used to be true. In both cases, RMDs limited tax-free accruals. Now "n" is no longer the same for traditional and Roth 401(k)s. Owners of traditional plans have to start taking their money out at 73; owners of Roths never have to take their money out. (Post-death minimum distribution rules still apply.)

One argument for changing the RMD rules appears to have been to make the treatment of Roth 401(k)s consistent with the treatment of Roth IRAs, which have never been subject to RMDs. Consistency is a good goal. Congress simply flipped the wrong way.

Flipping the wrong way costs the government money. Right now, even though 82 percent of employers offer a Roth 401(k) option, only 17 percent of participants take up the offer (see Figure 1). As more workers recognize the advantages of no RMD, that percentage will increase. As a result, the tax expenditure for retirement plans – a wasteful expenditure under any regime – will increase. If Congress is looking for money, introducing RMDs for Roth IRAs and restoring RMDs for Roth 401(k)s would not only make the tax benefits fairer but also raise revenues. That has to be a good thing!

Figure 1. *Percentage of 401(k) Plans Offering Roth 401(k)s and Percentage of Take-up by Plan Participants, 2008-2023*



Source: Vanguard. 2012-2024. "How America Saves."