Evaluating Roth and Pretax Retirement Savings Options

Weigh current tax status vs. future state when deciding.

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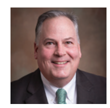

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KEY INSIGHTS

- Roth contributions are ideal for people who expect a higher tax rate in retirement, which could include those facing large required minimum distributions from existing pretax accounts.
- Pretax contributions are generally preferable for people who expect their income tax rate to decrease in retirement.
- For people who don't fall into one of those categories, Roth contributions may make sense for tax diversification, flexibility, and as a hedge against higher tax rates.

Many investors have the ability to save for retirement with Roth contributions. There are typically two ways to get Roth exposure:

- Roth IRA: You must have earned income and meet IRS income limitations. You are not required to take distributions, and you have access to your contributions, anytime, tax-free.
- Through your 401(k) plan[1]: Your plan must offer a designated Roth account. There are no income limitations, but distributions are generally required upon attainment of age 70½ unless you roll it over to a Roth IRA.

If you can save with a Roth option, it's important to evaluate whether you may benefit more from pretax or Roth retirement contributions.

A Roth contribution, unlike a traditional pretax contribution, doesn't reduce your taxes today, but qualified distributions[2] are tax-free. The primary factor to consider is whether your marginal tax rate will be higher or lower during retirement. If your tax rate will be higher later, paying taxes now with the Roth makes sense. If your tax rate will be lower, you want to defer taxes until then by using the pretax approach.

[1] Designated Roth accounts may also be offered in 403(b) and governmental 457(b) plans.
[2] Generally, a distribution is qualified if taken at least 5 years after the year of your first Roth contribution and you've reached age 59½.

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For someone whose marginal tax rate remains constant from the working years through retirement, choosing between a Roth and pretax contribution is a toss-up mathematically,[3] but Roth usually wins in a tiebreaker.

Unfortunately, tax rates are hard to predict due to changes in the law, income levels, or both. Consider the following hypothetical taxpayers that may help illustrate the pros and cons of the two types of contributions.

Millie, a single professional in her 20s, is currently in a low tax bracket. But a few promotions at work could easily put her in a higher bracket. Contributing to a Roth IRA or 401(k) means she pays the relatively low rate on taxable income now, but will pay no taxes on qualified distributions from the plan when she's retired. That seems like a reasonable deal, especially since it's really hard to guess what tax rates will be that far in the future.

Xavier, on the other hand, is approaching his peak earning years. He's in his 40s and is in a higher tax bracket than Millie. When he retires, his expenses will probably be lower—no more mortgage or college bills. As a result, his income from Social Security and the amount he chooses to draw from retirement accounts may be less than what he earns today. So, his federal tax bracket could go down in retirement. His state tax rate could also decrease, for example, if he moves to an income tax-free state like Florida.

For Xavier, taking the tax benefit now with a pretax contribution may make more sense than the Roth option. That's because he reduces his current taxable income now while paying a higher tax rate, and then makes withdrawals later in retirement at a potentially lower tax rate.

Bernard, our third taxpayer, is around ten years from retirement with a more complicated situation. His tax rate is not likely to fall after he retires. He has been a disciplined saver, contributing a healthy percentage of income to his pretax accounts for many years. After reaching age 70½, he must begin taking required minimum distributions (RMDs) from IRAs (and from his 401(k) if he has retired) even though he probably doesn't need all of that income to live comfortably.

Those RMDs could bump Bernard to a higher tax bracket. Qualified distributions from a Roth 401(k) or Roth IRA, on the other hand, would not create taxable income or increase Bernard's tax rate. Therefore, a Roth contribution may be preferable for Bernard to limit the RMD income taxed at a higher rate. Since Bernard seems likely to leave assets to heirs, in his situation, it's especially important to ask a tax or financial planning professional about multigenerational planning.

For people who are unsure which type of contribution may be more beneficial, the tie-breaker should often go to the Roth. Roth accounts are generally better for heirs since assets can continue to grow tax-free. Tax diversification also makes sense—using both Roth and pretax plans (and taxable accounts)—to hedge the risk of tax law changes or significant changes in personal circumstances.

Having a meaningful level of Roth assets helps retirees manage taxes effectively. Since the Roth 401(k) is a relatively recent development, many people haven't amassed significant balances and could benefit from building them now. (The Roth IRA has been available more than 20 years, but it has lower contribution limits and restrictions on high-income taxpayers.)

[3] Kutner, George W.; Doney, Lloyd D.; Trebby, James P. Investment Performance Comparison Between Roth And Traditional Individual Retirement Accounts. Journal of Applied Business Research (JABR), [S.l.], v. 17, n. 1, Feb. 2001. ISSN 2157-8834. Available at: cluteinstitute.com/ojs/index.php/JABR/article/view/2064. This analysis directly compares Roth and pretax contributions that result in equivalent impact on after-tax pay at the time of contribution. For most people, our view is that this methodology is more realistic than one which assumes an individual will fund a taxable account with the tax savings generated by a pretax contribution.

Who Benefits From Roth or Pretax?

Individual Profile		Example[4]	Likely Benefits From
Millie	Young person in a low tax bracket who is likely to be in a higher bracket later	Earns $50,000; 12% bracket (single). Next higher bracket is 22%.	Roth
Edward	Someone with tight cash flow who wants the company match while maximizing paycheck	Earns $30,000; 12% bracket (single). Contributes 6% to 401(k) to get full match. Pretax provides $216/year more net pay.	Pretax
Xavier	Person near peak earnings years who could be in a lower bracket during retirement	Household income $370,000; near bottom of 32% bracket (married). Next lower bracket is 24%.	Pretax
Bernard	Someone who already has large pretax balances and wants to minimize RMDs in retirement	Earns $160,000; 22% bracket (married). Approaching retirement with $3.2 million 401(k). RMD (around $171,000 at age 80[5]) plus Social Security is more than his spending need, and could bump him into 24% bracket.	Roth
Patricia	A prodigious saver who can afford to contribute the IRS maximum either way	Earns $130,000; 24% bracket today (single), with uncertain outlook for future rate. Can comfortably save $19,000 in 401(k). After-tax savings are effectively $4,560 higher with Roth.	Roth

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A person's ability to save could be another factor. If prodigious saver **Patricia** can contribute the maximum level to a retirement plan, the Roth effectively enables her to save more in a tax-advantaged manner. Saving the maximum ($19,000 for 2019, or $25,000 for someone over 50) ultimately results in more after-tax retirement assets for the Roth than a pretax contribution.

On the other hand, for someone struggling to save like entry-level **Edward**, the pretax approach may enable him to get the employer's full 401(k) match with less impact on take-home pay, because taxable income is reduced by the amount of his contribution.

Of course, the most important factor in reaching your financial goals is how much money you save. We recommend saving at least 15% of gross salary for retirement each year, including any employer match. That said, using different strategies like Roth and pretax contributions wisely can make a difference.

Before deciding on any strategy, we recommend discussing it with a tax accountant or financial planner.

[4] Brackets are for federal taxes, based on rates as of January 1, 2019. While rates are scheduled to revert to pre-2018 levels after 2025, those rates are not shown in this table. Note that reversion to generally higher rates in the future would make Roth savings relatively more favorable today. Income refers to gross earnings; current bracket reflects the standard deduction and potential retirement contributions. State taxes are not considered in the examples. Married status reflects joint filing.

[5] Based on 5.35% RMD at age 80 on $3.2 million balance. The steady balance assumes earnings on the account until that point are sufficient to fund withdrawals.

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