TO ROTH OR NOT TO ROTH

By Casey Tinius / CFP®

Should I pay taxes now, or wait and pay taxes when I'm retired? That is the decision being made when employees determine whether or not to use the Roth 401(k) option.

Roth 401(k) contributions are becoming more popular every year. When you contribute to a Roth 401(k) you are taxed on your pay **before** the contribution is made to your retirement plan, and all withdrawals are tax-free in retirement. With the traditional pre-tax 401(k) your pay is taxed **after** your contribution goes into your retirement plan meaning you are taxed on less income. With this option you will be paying ordinary income taxes on all your withdrawals in retirement.

The decision of which contribution type to use is not always cut and dried. If you think you will be in a higher tax bracket in retirement it makes more sense to fund the Roth 401(k). On the other hand, if you think you will be in a lower tax bracket in retirement it makes more sense to get the tax deduction now in your higher tax bracket and pay taxes on those dollars at a lower rate in retirement.

Given that tax rates are currently at historic lows for individuals, it is probably safe to assume that tax rates will be higher in the future. As a general rule, the 12% tax bracket is a good threshold to help make your decision. Individuals in the 12% bracket today will likely be paying a higher rate in retirement if they have the same level of income, assuming that tax rates will be higher in the future. If that is the case, it makes more sense to pay taxes today at a lower rate instead of paying a higher rate in the future when you take distributions. That decision is based on a lot of assumptions when it comes to tax rates, and obviously each individual's circumstances factor into the equation as well.

Once you reach the 22% bracket you are probably better off getting the tax deduction today and paying taxes in retirement when your income is likely going to be lower. Typically, the higher your tax bracket the more sense it makes to do pre-tax contributions. For an individual in the 37% tax bracket maxing out your 401(k) in a pre-tax account would save you about $7,500 in taxes. The only reason you would fund a Roth 401(k) at that tax bracket is if you make so much money that the $7,500 in tax savings doesn't mean anything to you.

One thing to keep in mind about Roth contributions is that your company match still goes into the pre-tax money type, meaning you will pay ordinary income taxes on those dollars when you take distributions. At the end of the day, everyone has different opinions on which type of 401(k) you should fund.

If you have questions about what contribution type is right for you contact us at landmark-info@wealthenhancement.com and let us help you make an educated decision!

Advisory services offered through Wealth Enhancement Advisory Services, LLC, a registered investment advisor and affiliate of Wealth Enhancement Group®.