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Roth vs Traditional 401(k)s

How to choose between plans

401(k) plans are tax-preferred investment accounts managed by employers. Traditionally, 401(k)s are funded with pre-tax dollars and taxed at withdrawal. Some plans have Roth options in which the account is funded with after-tax dollars and no tax is paid at withdrawal.

Both account types benefit from not paying taxes on gains when realized. There are restrictions on who can contribute and how much. We've outlined requirements and provide guidance on when to use each type of account.

Strategy

Since Roth and traditional 401(k)s differ in when they are taxed, this suggests a strategy of **paying tax when in a low tax bracket**. This means funding Roth 401(k)s in low tax bracket years and funding traditional 401(k)s in high tax bracket years. A typical strategy might be:

- Contribute to a Roth 401(k) in early years when earnings and tax bracket are low
- Contribute to a traditional 401(k) in mature working years when earnings and tax bracket are high
- Complete Roth conversions after retirement but before RMDs and Social Security, when income and tax bracket are low (See Roth Conversion synopsis)

Requirements and Limits

Plan Document

Each 401(k) plan is unique to the employer with specific rules outlined in the plan document. Some common features include:

- **Eligibility requirements:** The plan will state who can participate. Requirements may include age requirement, term of service, entry date and/or certain exclusions.
- **Employer match:** Employers may make contributions to employee accounts. The most common types are matching or discretionary profit sharing. All employer contributions are with pre-tax dollars.

Contribution Limits:

The most a taxpayer can contribute to an 401(k) in 2023 is $22,500. This amount is indexed for inflation. In addition, a taxpayer who will be 50 years or older by the end of the year may make an additional, catch-up contribution of $7,500.

Required Distributions:

There are required minimum distributions (RMDs) for 401(k) accounts, starting the year the owner turns 73. This applies to both the tradition and Roth options. However, a Roth 401(k) can be rolled to a Roth IRA after retirement or separation from service and therefore avoid RMDs. An employee who is still working at age 73 does not have to take RMDs provided he/she is not a 5% owner of the company.

Loans

Some 401(k) plans provide the option for participants to take out loans from their account.

Growth of Roth vs. Traditional 401(k)

	A Roth 401(k) (24% tax)	B Traditional (24% tax)	C Traditional (32% tax)	D Traditional (12% tax)
Earnings	$22,500	$22,500	$22,500	$22,500
Tax at contribution	*$5,400*	*$0*	*$0*	*$0*
Net contribution	$17,100	$22,500	$22,500	$22,500
Value after 5 years	$25,126	$33,060	$33,060	$33,060
Tax at withdrawal	*$0*	*$7,934*	*$10,579*	*$3,967*
Net Withdrawal	**$25,126**	**$25,126**	**$22,481**	**$29,093**

Columns A and **B** show outcomes for Roth and traditional IRAs after five years of 8% growth. Given a constant tax rate of 24% the after-tax results are equal. However, if tax rates change, then the after-tax value of the traditional IRA will be different. **Column C** shows that the net withdrawal is lower if taxes are higher in retirement (32% in the example) while **column D** shows that the net withdrawal is higher if taxes are lower in retirement (12% in this case).

Considerations

- ✓ RMDs are required for traditional 401(k)s. They are also currently required for Roth 401(k)s, but that will end in 2024.
- ✓ Roth 401(k)s can continue to avoid tax on portfolio earnings longer than traditional 401(k)s. For individuals who do not spend their full RMD, this enhances the tax benefits of Roth 401(k) accounts.
- ✓ Roth 401(k)s allow for greater contributions on an after-tax basis: Traditional 401(k)s and Roth 401(k)s have the same contribution limits (currently $22,500 per year). However, on an after-tax basis, this means more money can be saved to a Roth 401(k).
- ✓ Owning multiple account types (Roth 401(k)/IRA, traditional 401(k)/IRA, taxable accounts) provides flexibility: A taxpayer who has multiple account types can manage her taxable income in retirement by withdrawing spending needs from different accounts.

Have Questions About Saving for Retirement?

Our financial planners can help you decide between a traditional or Roth 401(k) account. Reach out to us today or visit us on the web for more information on how we can assist you with your retirement account planning and more.

T (732) 450 0147

infowwm@withumwealth.com

withumwealth.com