Traditional vs Roth 401(k) Retirement Account

An increasing number of company 401(k) plans are offering participants a tax-free Roth contribution option in addition to the traditional tax-deferred 401(k) choice. Deciding which one is right for you is an important exercise for all serious retirement-focused participants to complete.

A major advantage of contributing to a traditional 401(k) versus a Roth 401(k) is income tax deductibility. Contributors to traditional 401(k)s are allowed to deduct the full amount from their taxable income in the year of contribution. The higher your marginal tax bracket during working years, the greater the tax deduction benefit. Tax savings from tax-deductible contributions to a traditional 401(k) plan can be used to pay for monthly living costs, pay off debt, or can be reinvested into after-tax retirement savings accounts.

Conversely, Roth 401(k) contributions do not receive an income tax deduction on current-year contributions. But unlike traditional 401(k) accounts, earning grow income-tax free. This can be a huge benefit over long periods of time.

One deciding factor in helping to choose which plan is right for you is to evaluate your current marginal income tax rate versus what you think your tax rate will be in the future. If you have a higher income tax rate now than you expect during retirement, that favors traditional 401(k) contributions. If you have a lower tax rate now than you expect during retirement, that favors Roth 401(k) contributions.

Another deciding factor is the amount of tax-deferred retirement savings you already have accumulated. If you have all tax deferred retirement savings, you may be paying a higher tax cost later when you begin to take taxable distributions from these accounts. Adding income-tax-free Roth 401(k) accounts can help produce a more tax-efficient distribution during retirement.

Also, increased taxable income after age sixty-five due to traditional IRA/401(k) discretionary distributions will not only increase the amount of taxes you pay but could also increase tax on income benefits received from Social Security and increase the costs of Medicare Part B premiums. Note that Medicare premiums are adjusted based on your modified adjusted gross income (MAGI) two years prior to your current Medicare premium year. For 2018, use 2016 income tax returns to calculate any increase above the base Medicare part B premium in 2018. I know, this stuff is not simple!

Traditional IRA and 401(k) accounts have required minimum distributions (RMDs) for nonworkers over the age of seventy and a half. Even if you don't need the money at that point of your life, you are required to take a specified minimum amount out of the tax-deferred IRA/401(k) and pay income tax on that amount in the year it is received.

Roth 401(k) owners are required to do the same unless they are still working for the employer who has offered the Roth 401(k) plan. However, it's possible to roll over your Roth 401(k) into a Roth IRA before reaching age seventy and a half which eliminates this requirement to take mandatory distributions. Before you make a roll-over request, you should carefully consider others factors such as fees, investment choices, distribution options, legal protection, loan provisions, and any other particulars of each type of account.

For beneficiaries of your retirement accounts, inheriting money in a Roth 401(k) could be good tax news provided that the Roth 401(k) is at least five years old prior to distribution. In that case, no income taxes would be due on the distributions from the inherited Roth 401(k). Traditional 401(k) accounts usually give the beneficiary a few choices for payout depending on the relationship to the account owner and the 401(k) plan administrators allowed provisions for payout. With the exception of a spousal beneficiary, all payout options to non-spouse beneficiaries from a traditional 401(K) are taxed as ordinary income in the year of distribution. Professional guidance in this area is extremely important as beneficiary tax laws can be complex and dependent on specific conditions for the distribution from a qualified plan.

When considering income sources in retirement, most retirees have up to three types of income for tax purposes: Taxable, tax-preferenced, and tax free. Both

Roth IRA and Roth 401(k) plans offer tax-free options that give the retiree the and the beneficiary the ability to prioritize income distributions in a more tax-efficient manner. Because Roth IRAs have no required distribution requirements at any age, this feature gives the account owner additional flexibility when planning an optimized retirement-income distribution strategy.

Creating a balance between taxable, tax-preferenced, and tax-free future income sources can make a big difference in the amount of after-tax money you receive when it comes time to crack some of your nest eggs for retirement-income omelets!

This article is for information purposes only. Always consult a professional tax adviser for details about how taxes might be affected for your specific situation *before* and not *after* you take action.

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