BUSINESS

Road to Retirement: Should you use a Roth 401(k)?

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If you're like a lot of people, you probably have a 401(k) plan at your place of work. For many years, the only contribution option in a 401(k) was to contribute money on a pre-tax basis and then pay tax on that money once you started withdrawing it in retirement. But about 12 years ago, the law was changed to allow companies to offer Roth 401(k) features.

Companies were slow to adopt them, but today many employers offer their employees the option to use either a traditional 401(k), Roth 401(k), or both. Yet many employees don't know much about the Roth feature or when they might want to use it.

Let's start with a summary of the traditional 401(k) plan. In these plans, you contribute a portion of your pay into the plan, and receive a current income tax deduction for the amount of your contribution. Then when you retire and distribute the money, you pay income tax on the distributions.

Photograph by Ellen Jaskol

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For instance, let's assume you contribute $10,000 into your 401(k) plan and you have household income of $100,000. When you do your taxes, you will get to deduct that $10,000 from your income and you are only taxed on $90,000 of income. Assuming you pay about 25% in combined federal and state income taxes, the deduction saves you about $2,500 in taxes. That savings makes it easier to contribute the $10,000 into your plan.

The money in your 401(k) plan then grows tax deferred until you retire and start to take it out. Assuming your tax rate is still 25%, you'd pay income taxes at 25% of whatever amount you choose to withdraw.

But a Roth 401(k) essentially has the opposite type of tax treatment. With a Roth 401(k), you do not receive a current income tax deduction for your contribution. You pay taxes on the money you contribute into the plan. But when you distribute the money, you do not pay taxes on it. That's the difference. You pay tax when you contribute, but not when you distribute.

So, which is better: a traditional or a Roth? Well, that all depends on your tax rate. I'll walk you through a short example.

Let's assume you contribute your $10,000 into a traditional 401(k) plan and it grows for 20 years at 6%. By the time you retire, it's worth about $32,000.

Let's compare this to the Roth feature. We'll assume you have the same $10,000 to contribute to your Roth 401(k) plan, but you have to pay tax on that money. If your tax rate is 25%, then you will only have $7,500 to contribute instead of $10,000.

The $7,500 goes into your Roth 401(k) plan and grows tax deferred for 20 years at 6%. At retirement, it's then worth $24,053. You take that money out of your plan and pay no tax on it, which leaves you with $24,053 to spend … the exact same amount as with the traditional plan. Seems odd that you end up with the exact same amount of money doesn't it? It's odd but accurate, and it all has to do with your tax rate.

If your income tax rate at the time you contribute money is the same as the income tax rate when you distribute the money, it does not matter which one you use. You will end up with the same amount of money. In our example, the tax rate was 25% when contributed and 25% when distributed, which is why you ended up with the same amount of money to spend.

But how do you know what your tax rate will be when you retire? You don't. You have to make an educated guess, and that's how you decide whether to use a traditional or Roth feature.

Here are the three basic options to consider:

1. If your income tax rate is low today and you think it will be higher when you retire, you should consider the Roth 401(k). This means you are paying a lower tax on the money when contributed and avoiding a higher tax when distributed.
2. If your tax rate is high today and you think it will be lower in retirement, you should consider a traditional 401(k). This means you are avoiding a higher tax when contributed and paying a lower tax when distributed.
3. If you are not confident about whether your tax rate will be higher or lower when you retire, then you may want to split your contribution and put some in a traditional 401(k) and some in a Roth.

Most people's tax rates fall somewhere in the middle, and tax rates change all the time. Thus, it's hard to know if your rate will be higher or lower when retired, so splitting may be your best bet.

Charlie Farrell is a CEO of Northstar Investment Advisors LLC. This article

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