Financial FITNESS

ROTH VS. TRADITIONAL 401(K)S: A Taxing Dilemma

Article Source: Scott Morrison / Morrison Nordmann & Associates / Securities America

If your employer offers a 401(k) retirement savings plan and you can afford to participate, the decision to invest should be easy. Relatively small contributions now can pay big dividends in the long run, especially if your company offers any type of matching funds.

Once you decide to invest, however, you may have an additional decision to make. After decades of only providing one type of 401(k) account, half of all employers now provide employees with both Roth and Traditional options. These plans are identical in many respects, and both are powerful vehicles for creating long-term wealth. There's only one essential difference between the two - and it all comes down to taxes.

Tax Now Or Tax Later?

The Traditional 401(k), contributions are made with pre-tax dollars. This means your current income tax bill will be lower, and your contributions and interest can grow tax-deferred until you retire. When you eventually withdraw your money from a Traditional account, it will be taxed as ordinary income.

With a Roth 401(k), contributions are made with after-tax dollars.

This account won't give you the same up-front tax break, but you'll enjoy a major benefit when you retire. At age 59 1/2, you can withdraw your contributions and earnings tax-free, as long as you've held the account for at least five years.

Not sure which is best for you? You'll need to consider whether it makes more sense to pay taxes on your contributions now, or to wait until you take out the money. And to answer that, you'll need to make an educated guess about your future income.

Forecasting Your Financial Future

Ultimately, the decision between Roth and Traditional 401(k)s comes down to one question: Do you think your tax bracket will be higher, lower or the same when you retire?

According to conventional wisdom, a Traditional 401(k) account is perfect for experienced employees nearing retirement - those who have already reached the highest-earning stage of their career. Traditional contributions will reduce your current taxable income, and may take you into a lower tax bracket. Those immediate tax savings can help create the largest possible nest egg at retirement.

On the other hand, if you're starting your career and expect to enter a higher tax bracket before you retire or if you worry that taxes will go up significantly by then, a Roth account may be the right choice for you.

The truth is, there's seldom an obvious solution. Individual situations vary widely, it's difficult to predict your future income level, and tax laws could change dramatically by the time you retire. But there is some good news - you may not have to pick just one.

The Best Of Both Worlds

For many investors, the right solution may be to contribute to both types of 401(k). One option, if your employer offers matching or profit-sharing contributions, is to put money into a Roth account and keep the matching funds (which can't be contributed to a Roth) in a Traditional one. Many employers allow you to split your contributions 50-50 between the two types of accounts, or to decide year-by-year where to contribute.

By saving in accounts with different tax treatments, you can help balance your taxable and tax-free withdrawals. This idea, called tax diversification, gives you more control over your tax situation, and minimizes the risk of incorrectly guessing your future tax rate.

Of course, the best source of 401(k) guidance for your unique situation is just a phone call or email away to your financial advisor.

Securities offered through Securities America, Inc., Member FINRA/SIPC.
Advisory services offered through Securities America Advisors, Inc.
Morrison, Nordmann & Associates and Securities America are separate entities.

Forbes.com, "10 Changes To 401(k)s Employers Should Make Now," October 20, 2014.
2 Usnews.com, "Roth or Regular: Which 401(k) is Best?," March 12, 2013.