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Pre-tax vs. Roth 401(k) contributions – a guide for participants

Contributing to your employer's 401(k) plan is a great way to save for retirement, but the type of contributions you choose can have a huge impact on your finances both for now and for the future. The issue is, most employees don't understand the differences between the Pre-tax 401(k) and the Roth 401(k), or the impact such a decision will have on their later years.

There are several similarities.

Pre-tax and Roth 401(k) contributions are both deducted from payroll, so they are contributed throughout the year, rather than in one lump-sum. Both are invested for a long period of time, and the earnings are not taxable to you while they are invested. They have the same annual contribution limits (currently $20,500 a year for workers under 50 and $27,000 a year for those 50 and over). This is an annual, individual limit, meaning the limit applies to the total of all contributions, no matter if pre-tax or Roth contributions, or a combination of the two. Both may have distribution options available to you while still employed, depending on the plan design, and both may receive a match from the employer, again, depending on the plan design.

The main **difference** between Pre-tax and Roth 401(k) contributions is the timing of the taxation – when tax is paid.

A Pre-tax 401(k) contribution is deducted **before** federal withholding taxes are calculated. They are still subject to FICA and Medicare taxes, but reduce your current taxable income. This means that on a paycheck of $1,000 with a 10% deferral, you are taxed on $900. Over the course of a year, this can result in a large tax savings if you are in a higher tax bracket. When you take those funds out later in life, the money you distribute is taxed as standard income.

A Roth 401(k) plan is an after-tax contribution. Using the same example above of a paycheck of $1,000, your withholding taxes are calculated on $1,000. When you access those funds at retirement, both the contributions and the earnings thereon are distributed completely tax-free, assuming certain criteria are met. You must be at least age 59 ½, and it must be at least five years from your first Roth 401(k) contribution in order to distribute tax-free. If you distribute the funds prior to the criteria being met, the income on those funds is taxable and subject to the 10% excise tax on premature distributions. Unlike Roth IRAs, Roth 401(k) accounts are subject to the minimum distribution requirements. They must be rolled out of the plan and over to a Roth IRA by the time you reach age 72, or terminate employment, whichever is later, so the minimum distribution rules do not apply. For owners or certain members of their family, the account must be rolled out prior to reaching age 72, even if you continue to work.

Which Plan is right for you?

Whether you contribute to a Pre-tax or Roth 401(k) account depends on your personal circumstances. Here are a few things to consider helping you make the right choice.

- **Your age and the age you plan on retiring;** a large part of the decision is to determine how long the funds will be invested and will the bulk of the money at retirement age be your own contributions or the earnings on those contributions. It may make sense to pay the tax on the contributions now in order to take out the earnings tax-free

- **Your ability to make contributions;** if the tax savings allows you to make a greater contribution now, the pre-tax method may make more sense for you. At a tax bracket of 15%, a Pre-tax deduction of $100 feels like $85, but a Roth deduction feels like $100. If you would make the same contribution either way, then paying the taxes on the contributions now so you don't pay taxes on future distributions may work out better for you in retirement.

- **Your current and expected future income;** if you are just starting out in a field that will pay a much higher salary in the future, the current deduction may not make a difference to you now and will start the five year clock running, while you may want the deduction in the future.

- **Your expected tax bracket when you retire;** if the tax rate stays the same, then the net effect is the same either way. If your tax rate changes and you would hope to be in a lower tax bracket in retirement, the Pre-tax account gives you the benefit of the reduction of income now while you pay less in taxes in retirement.

- **Your expected financial needs and other sources of income when you retire;** keep in mind, any employer contributions (and the earnings thereon) will always be taxable to you when you receive them. Your tax professional may suggest taking all your non-taxable income first, or a combination of both in order to minimize your taxes based on your other income or financial needs.

In Conclusion:

The decision to make Pre-tax or Roth 401(k) contributions can be especially complex and vary from individual to individual. The decision should essentially be based on expectation of future income, needs and projected taxes. Don't let the complexity keep you from contributing at all. The beauty of the situation is that nothing is carved in stone forever, your elections can be changed at least annually, depending on the rules of the plan. The most important thing is to start making contributions as soon as possible, as delays in contributions have a greater opportunity cost than any tax ramifications. Feel free to ask your plan's administrator, investment advisor or your own tax consultant to see what would be most beneficial to you.

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