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Reilly Financial Advisors

Wealth Strategies

Saving For Retirement: Tax Deductible vs Roth Contributions

Part 2 of 12

Saving For Retirement: Tax Deductible vs Roth Contributions

Regardless of how savvy one is at choosing investments, the selection of the type of retirement account is often just as important as the investment choice. If an investor lacks the understanding of which type of account is most effective for their personal financial situation, they could end up paying thousands or even hundreds of thousands more in taxes over a lifetime. Taxes can be a drag on overall investment returns and retirement savings. It is encouraging to know there are a variety of tax advantaged accounts that incentivize retirement savings. Depending on the type of plan offered by your employer (if any) and your level of income, you may be able to benefit from present day tax savings, tax-deferred growth, or potentially tax-free income in retirement. But beware, all is not created equal!

When it comes to retirement savings accounts, the question is often asked: ***Should I make pre-tax or Roth contributions?*** This is an important question and should be answered based on each individuals own situation. By starting with the types of accounts and contribution options available, we will help lay the groundwork for answering that question. Pre-tax contributions to a plan provide an upfront tax benefit in the form of reduced income today thus less income you must pay taxes on. When those pre-tax funds and earnings are withdrawn in retirement, the distribution is treated as ordinary income. Roth contributions are made with dollars that have already been taxed, providing no additional tax benefit today. However, qualified distributions of those Roth funds in retirement are distributed tax free. In order to understand which one is best for you it is important to take a step back and explain the different types of retirement savings vehicles and how distributions from each account are treated in retirement. We'll review retirement investment accounts that fall into four key categories:

1. **Taxable Investment Accounts (e.g., Individual , Joint Tenant, Personal Trust)**
2. **Deductible Tax-Deferred Accounts (e.g., Traditional IRA, 401(k), 403(b))**
3. **Non-Deductible Tax-Deferred Accounts (e.g., Annuities, after-tax contributions to Traditional IRA or 401(k), and certain Life Insurance contracts)**
4. **Tax Free Distribution Accounts (e.g.,Roth IRA & Roth 401(k))**

Taxable Investments

Taxable investment accounts are the basic building block for investing. They refer to individual, joint accounts, and personal trust accounts set up for the purpose of investing in stocks, bonds, mutual funds, etc. Sometimes they are referred to as *brokerage accounts*. According to Uncle Sam, you owe him a cut of any investment earnings. However, to incentivize investment in business, the government has decided to give taxpayers a break in the way of a capital gains tax. Capital gain is the increase in value of a capital asset (investment).

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The capital gain tax is owed only when a gain is realized. The gain is realized when that particular investment that increased in value is sold. The capital gain is categorized as a short-term (holdings of one year or less) or long-term gain (holdings of more than one year).

Investing in a taxable account can be efficient in several ways:

1. Preferential tax rate for long term capital gains compared to ordinary income (wages, interest)
2. Preferential tax rate for qualified dividends
3. Taxes on capital gains are not owed until the capital gain is recognized
4. Ability to add and withdraw money as you please without penalty
5. Unrealized gains may receive a step-up in cost basis at death

Deductible Tax-Deferred Growth

Tax deferral is the process of delaying the payment of income taxes on investment returns. A taxable investment account recognizes dividends, interest, and capital gains as they happen and taxes may be owed on those earnings annually. A tax deferred account allows the delay of paying taxes on those same earnings. There is no tax until the money is withdrawn or distributed to the account holder. Additions to the account can be contributed with pre-tax dollars potentially allowing you to save more. Pre-tax contributions are available through employer-sponsored plans such as a 401(k). Traditional IRA contributions may be deductible.

Tax deferral and pre-tax contributions can be beneficial in several key ways:

1. The money you would have spent on taxes remains invested. You can potentially accumulate more dollars in a tax deferred account due to compounding of the investment without an annual tax drag
2. You may be in a lower tax bracket at retirement when you make withdrawals from your accounts
3. Pre-tax contributions allow you to reduce current taxable income

Non Deductible Tax-Deferred Growth

For high income earners that may be looking for additional ways to defer tax on retirement investments, there remains nondeductible tax deferred accounts. In this case you maintain the deferral of earnings, but do not receive a tax deduction for contributions. However, since your contributions were already taxed, they are non-taxable when distributed from the account. This is commonly seen in annuities and life insurance contracts. However, it can also be achieved through after-tax contributions to 401(k)s and Traditional IRAs.

Non-deductible tax deferral (aka after-tax contributions) can be beneficial in a few ways:

1. Earnings remain tax-deferred until withdrawn or distributed
2. Contributions are not taxed again, but are generally taken out pro-rata with the earnings

Tax-Free Income During Retirement

Tax deferral is not the same as tax free. Tax free means that no income taxes are due at all. Tax free income is available through a Roth IRA, and to those lucky enough to have Roth employer-sponsored savings plans. When you contribute to a Roth account, you don't receive a current tax benefit like you would with a pre-tax contribution. But, your earnings can still grow without having to pay taxes on them each year. Additionally, qualified distributions can be withdrawn tax free.

Roth savings can be beneficial in several ways:

1. Less restrictive eligibility
2. Tax free income when you make qualified withdrawals
3. Minimizes taxes for heirs

How Do I Know Which One Is More Suitable For My Individual Situation?

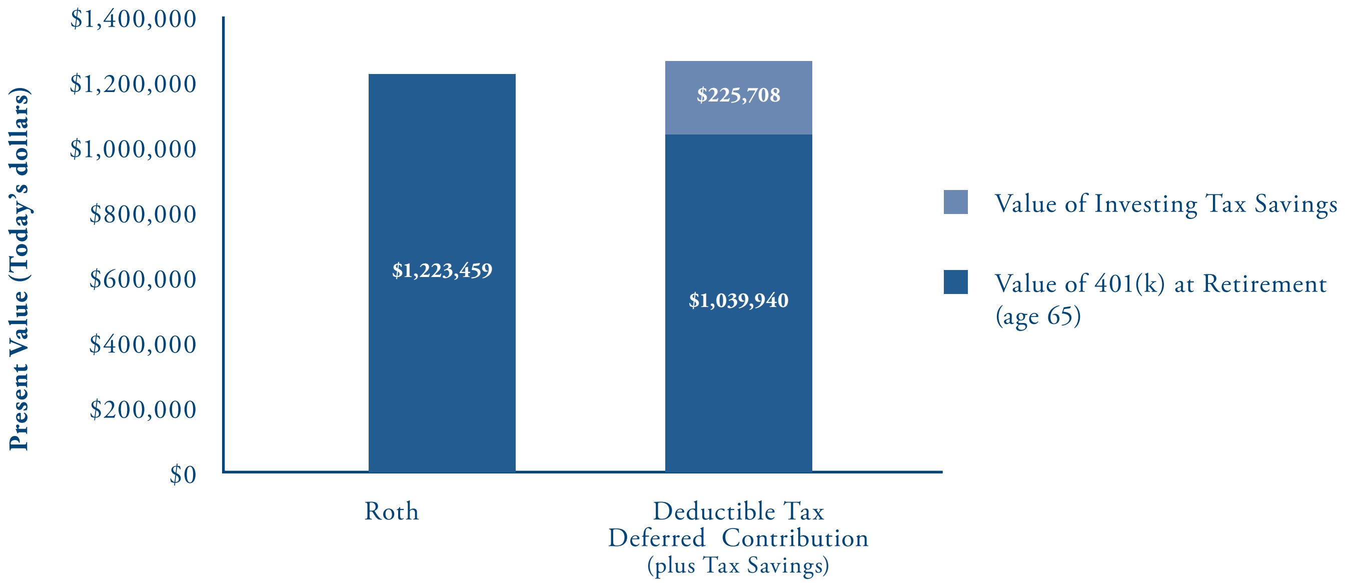
A successful retirement savings strategy will likely include a combination of the above savings accounts, especially for high income earners. However, the reality is for most of us savings may be limited and the highest priority should be a decision between two retirement accounts: **deductible tax deferred** (pre-tax contributions to a 401(k) or Traditional IRA) or **Roth** (after-tax contributions to a Roth 401(k) or Roth IRA).

Should you make deductible tax deferred (pre-tax) or Roth contributions to your retirement plan? The conventional approach is to compare your current tax bracket with what you anticipate your bracket will be in retirement. If you expect your tax bracket in retirement to be lower, deductible tax deferred (pre-tax) savings may be better. Conversely, if you expect your tax bracket in retirement to be higher, Roth contributions may be better. For a more detailed approach, calculate and compare the total value of savings at retirement assuming deductible tax deferred (pre-tax) contributions and then Roth contributions. That type of calculation may look something like the following example:

Let's assume Dan is age 35 and plans to retire at 65. Dan has a Roth 401(k) available at work and can save $10,000/yr. His current tax rate is 25% and holding all else equal, expects his tax rate in retirement to be 15%. Assuming he can earn an average return of 8% on his investments after fees, he wants to know whether he should make a pre-tax or Roth contribution with the $10,000.

Making deductible tax deferred (pre-tax) contributions could be worth $42,189 more than making Roth contributions.

After-Tax Value at Retirement



How was this calculated?

Step 1: First we calculated the value of a Roth account if Dan contributed $10,000 per year for 30 years earning an assumed 8% per year. This equals $1,223,459. Since withdrawals from a Roth account are not taxed, the total value remains $1,223,459.

Step 2: Next, we calculated the totals for a deductible tax deferred (pre-tax) account. Again, we determined the value of $10,000 per year for 30 years earning an assumed 8% per year. This is the same amount as the Roth account total of $1,223,459. However, contributions and all earnings in a deductible tax deferred (pre-tax) account are taxable when they are withdrawn. After taxes, the value of the deductible tax deferred (pre-tax) account would be $1,039,940.

Step 3: Dan receives a current year tax deduction for any pre-tax elective deferral contributions. So we take it one step further and assume he invests the tax savings of $2,500/yr. ($10,000 deferral x 25% current tax rate) in a taxable investment account. If the tax savings were invested for 30 years at an assumed 8%, the account would be worth $225,708 at retirement. Note: capital gains taxes were subtracted from earnings annually.

Results Summary

	Roth	Pre-Tax
Total Contributions	$300,000	$300,00
Total Retirement Account Savings before Taxes	$1,223,459	$1,223,459
Taxes at Retirement (15%)	$0	$183,519
Value of Investing Tax Savings		$225,708
Value of Retirement (age 65)	$1,223,459	$1,265,648

From the example above, it seems like a simple calculation could give us a clear distinction between the benefit of deductible tax deferred (pre-tax) vs Roth savings. Unfortunately, in reality things are not so black and white. Personal circumstances such as eligibility, age, income, fixed income in retirement, estate goals, and other factors (some of which can't be quantified) make this decision more complex:

Employer Eligibility: Do you have a retirement plan through your employer such as a 401(k)? If so, is it a Roth 401(k)? Sometimes the opportunity to make certain types of contributions is limited by your eligibility status. If you have an employer -sponsored plan your ability to contribute to a Traditional IRA may be limited. In many cases employer-sponsored plans do not allow Roth contributions or after-tax contributions.

Age: How close are you to retirement? For those in the beginning of their careers, Roth contributions may be more favorable due to two factors: time and potential income. Current income is most likely the lowest in the beginning of our careers, allowing savers to take advantage of lower tax rates and let the benefits of compounding interest significantly increase tax-free savings for retirement.

Income: Are you earning a higher income? Age may just be a correlation to a more impactful variable: income. Income can play into the decision in a few ways. One, your ability to make Roth IRA contributions is limited by your income. Roth contributions are phased-out for high income earners. Two, high income earners carry a higher current tax rate. Deductible tax deferred (pre-tax) contributions may be more favorable due to both removing current taxable income and allowing more savings to be put away.

"These are just some of the considerations that should be evaluated when deciding whether deductible tax deferred (pre-tax) or Roth contributions are best for your individual situation."

This should not be confused with conversions. Prior to 2010, you could not make a Roth conversion if your adjusted gross income was above $100,000. However, the IRS has since changed this and there is no longer an income limit on Roth conversions.

Retirement Resources/ Income: Will you have fixed income during retirement due to a pension, rental income, annuity, or to a degree a high social security check? Higher fixed income during retirement could push distributions into a higher tax bracket. Having tax free income from a Roth account would minimize taxes and could provide an opportunity for more effective tax planning strategies.

Estate Planning: Is one of your goals to pass on a portion of your assets to heirs? If you already have significant assets to afford retirement, Roth savings offer the opportunity to pass tax free assets onto beneficiaries. Additionally, you are not required to take distributions from those accounts once reaching age 70 ½, which is mandatory with deductible tax deferred (pre-tax) savings, allowing greater savings to be accumulated and passed on.

Distribution Needs: When and what will your savings be used for? Will you need those distributions early? Each type of savings has certain distribution requirements that must be met in order to be considered qualified. That is, if withdrawals are taken that don't meet these criteria, with some exception, a 10% tax penalty may be applied in addition to any income tax.

These are just some of the considerations that should be evaluated when deciding whether deductible tax deferred (pre-tax) or Roth contributions are best for your individual situation. In some cases, the best strategy may be a combination thereof. While using many of the free tools and Roth vs deductible tax deferred (pre-tax) calculators online is a good start, using a professional financial advisor can help you navigate through those other sometimes hidden considerations, allowing for a strategy customized to fit your personal needs.

About RFA

Reilly Financial Advisors is a fee-only Registered Investment Advisor, aimed at helping our clients both define and achieve their individual financial goals through four unique service offerings:

1. **Wealth Building – for those still accumulating their investment portfolios**
2. **Wealth Management – for those who have amassed their savings and have specific needs associated with their wealth**
3. **Wealth Legacy – for those who have accumulated a significant amount of wealth and face unique wealth transition needs**
4. **Corporate Retirement Services – tailored solutions for plan sponsors and participants**

RFA, founded in 1999, services clients around the United States and in more than a dozen countries worldwide. As an independent advisor, we are able to provide our clients with the highest level of Fiduciary services which allows us to make investment decisions based solely in the best interest of our clients. Our goal is to be our client's first point of contact for all of their financial needs, serving as a trusted financial partner for the long term.