PROTECT YOUR POT OF GOLD FROM BAD ADVICE

THE END OF THE RAINBOW

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Roth Versus Traditional 401(k) Contributions

If you are a great saver who wishes for more tax-protected retirement account space, Roth may be for you even during peak earnings years.

by JAMES M. DAHLE, MD, FACEP

Question. ***My 401(k) now allows me to make Roth contributions. Should I do that or continue making the tax-deferred contributions I have been making for years?***

A. It turns out that this is a very complex question, and anyone who pretends the answer is simple doesn't really understand all the factors involved. There is no universally correct answer, only a right answer for you. However, rather than spending a lot of time worrying about how best to manage this decision, realize that both tax-deferred and Roth 401(k) contributions are very good things and both have great advantages. Also, when in doubt, it never hurts to just split the difference, minimizing regret either way.

Roth contributions are made with money that has already been taxed. When the money is finally withdrawn from the account in retirement, both the original principal and the earnings come out completely tax-free. Tax-deferred, or traditional, 401(k) contributions provide you a tax break in the year you make your contribution. They also grow in a tax-protected manner, but upon withdrawal, the entire principal and earnings are taxed at your full marginal tax rate. So the first factor to consider when deciding between Roth and traditional 401(k) contributions is the difference between the tax rate at which you would contribute the money and the tax rate at which you would withdraw it.

For a resident, who is most likely in a very low tax bracket, making Roth contributions is usually the right move. However, it can increase student loan payments due under the Income-Based Repayment and Pay As You Earn programs, as well as decrease any forgiveness received under these programs or the Public Service Loan Forgiveness program. For an attending in peak earnings years, the right move is usually to make tax-deferred contributions and then use that money to "fill up" the 0 percent, 10 percent, 15 percent, and 25 percent brackets in retirement. Putting money away at a 33 percent marginal tax rate and then withdrawing it at an effective tax rate under 25 percent is a winning formula.

Unfortunately, there are numerous other factors involved that complicate the decision for many people. First, it is nice to have both tax-free (Roth) and tax-deferred accounts available to you in retirement to provide tax diversification. This puts you in control of your retirement tax rate. You can withdraw from tax-deferred accounts up until you hit the higher tax brackets, then use your tax-free money if you need additional income. If your ratio of tax-free to tax-deferred accounts is very low, it may be more worthwhile for you to make Roth 401(k) contributions even in your peak earnings years. However, if you have a significantly sized Roth IRA from your resident years and you make annual backdoor Roth IRA contributions for you and your spouse, you may have a decent ratio already and would be better off maximizing your tax-deferred contributions.

Making Roth contributions also allows you to put more money into retirement accounts, which have many tax, estate-planning, and asset-protection benefits. Because the limit is the same ($18,000 in 2015 for those under 50) for both a Roth and a traditional 401(k) employee contribution (employer match and profit-sharing contributions are always tax-deferred), if you choose Roth, you will have more after-tax money in your account. Think of it this way: you only own some of the money in a tax-deferred account. Uncle Sam owns a certain percentage, and you are just investing it for him until withdrawal, at which time you get your share and he gets his. However, with a Roth account, you own the whole thing. If you are a great saver who wishes for more tax-protected retirement account space, Roth may be for you even during peak earnings years. Great savers also run into the issue of having a very large tax-deferred account. Once your tax-deferred accounts are more than $2–$3 million in today's dollars, the required minimum distributions alone will get you into a high tax bracket, so there won't be much of an arbitrage between today's tax rates and tomorrow's. It turns out that the more you save for retirement, the less benefit you will see from using tax-deferred accounts. The same is true if you have a lot of taxable income from Social Security, a pension, or real estate investments.

Your personal economic and political views may also impact your decision. Some people are very concerned that the tax brackets themselves will be much higher in retirement, so they prefer to pay taxes now and use Roth accounts. Others are worried the government will change the law in order to tax money contributed to Roth accounts twice. These folks take the "bird in the hand" approach by using a tax-deferred account. Frankly, I think planning is done best using current law as your guide since predicting future Congressional acts seems to require a crystal ball.

There are also other, more minor, considerations. For example, if you plan to move from a state with a state income tax to a tax-free state in retirement, you should favor tax deferment. Although most physician families won't qualify for much significant college financial aid (aside from loans), using Roth accounts can lower the expected family contribution on the Free Application for Federal Student Aid. There are also estate-planning considerations. Estate tax is levied against the total amount of the account. Therefore, if you expect to have an estate tax problem, it might be best to favor Roth accounts since you have more after-tax money available for the same-size account. Heirs also prefer to inherit a tax-free Roth IRA over a traditional IRA. It is also possible that the total tax due could be reduced by leaving the traditional IRA to an heir in a lower tax bracket.

Confused yet? With good reason, you might be—it's a complex decision. Roth 401(k) contributions are a great option to have, but the decision about whether to make Roth or traditional contributions is a complex one that depends on many personal and nonpersonal factors that may change in the future. Following these guidelines can help you optimize your retirement savings and tax situation.

GENERAL GUIDELINES

THAT SHOULD HELP WHEN EVALUATING THIS DECISION:

1. If you're a resident or military member, maximize Roth contributions.
2. If you're in a low-income year for any reason, such as a sabbatical, use Roth contributions.
3. Use a personal and spousal backdoor Roth IRA each year. That way, even if you choose to make all tax-deferred 401(k) contributions, you're still getting some money into Roth accounts.
4. If you can pay the tax with money in a taxable account and expect to work part time or retire in your 50s, then consider making Roth conversions during those years before receiving Social Security or a pension to "fill up the lower brackets."
5. If you save and invest more than 20 percent of your gross income, lean a little more toward Roth investments. If you save and invest less, use tax-deferred accounts preferentially.