Traditional 401(k) Versus a Roth 401(k): What's Right for You?

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FOR SO MANY, a workplace 401(k) retirement savings plan is their main pathway to a financially secure retirement. The keyword, of course, is "savings," and the key instruction is, "Start early and never stop." You might have heard that you should save 15 percent of your pay from your very first job.

I often ask young people just out of school what they think would be a good starting salary? If they say $50,000, I ask them if they would take the job if it paid $42,500. They often answer yes. I then suggest that they pretend they are starting at $42,500 and plan to live on that salary. They'll never miss the 15 percent — set aside automatically from their paycheck into their employer-sponsored retirement account — and they will be off to a great start, so much better than those who only save as much as the employer match, as little as three percent. It could take them years to get to the 15 percent savings level — if they do get there at all.

You may have options in your 401(k) plan to save in a traditional tax-deferred account or in a Roth account. What's the difference, and which should you choose? You can use one of the many calculators to determine your optimal answer, but there are so many assumptions you need to include that impact your savings over such a long-time horizon. There's a much simpler approach to answering this important question.

When it comes to savings, "Start early and never stop."

As a general rule, the younger you are and the lower your tax bracket, the more you should consider the Roth option. The higher your tax bracket, the more valuable the tax deduction of the tax-deferred traditional contributions. But regardless of your tax bracket, keep this simple rule in mind: Tax-free growth over a long period is much better than tax-deferred growth. When you retire and can make tax-free withdrawals, it could save you from higher tax rates that could be a substantial drag on your retirement lifestyle. And considering our rapidly growing national debt, tax rates are likely to be considerably higher in the future than they are today.

Here are two examples: In a traditional tax-deferred 401(k), if you save $10,000, your take-home pay is reduced by $7,800, assuming a 22 percent tax bracket. So, you get a $10,000 long-term investment at a cost of $7,800. That has been the hallmark attraction of 401(k) investing since the inception of these plans in 1981. You have the benefit of investing the tax money you would have owed — and for many years. A great deal. Then, in retirement when you're using your savings, you pay tax on your withdrawals. If your tax rate is lower in retirement, that might make perfect sense. But I wouldn't count on low tax rates. As well, there are other valuable benefits to having after-tax dollars to draw on.

Generally, younger workers in lower tax brackets should consider the Roth 401(k) option.

If you direct your annual salary deferral to the Roth component in your plan, your after-tax $10,000 investment reduces your take-home pay by that amount. Can you afford to give up the current cash flow benefit for your long-term security? Those who commit rarely miss the $2,200.

What if you have significant balances in your 401(k) and you are advanced in your career and planning to retire in less than ten years? Should you redirect all or possibly half of your annual contributions to the Roth? You may have fairly strong cash reserves, your children grown and your mortgage nearly paid off. And you might be saving the maximum allowed annual 401(k) contribution of $26,000. Can you absorb a reduction in spendable income of $2,200 to $5,700 to build something much more valuable, a tax-free retirement balance of $100,000 to $300,000? Consider also that when you retire you are still expecting a long-term horizon, and a portion of this balance after withdrawals, will continue to grow on a tax-free basis.

Remember that we are only talking about your annual contributions to the plan, not the sizable balance you have accumulated over a long career. Long-term, tax-free growth is worth giving up some current spendable income. And if your current cash flow needs are too great, start directing a third or half of your current salary deferrals to the Roth, then ratchet up your contributions every year. You are not likely to miss the cash, and you will be in a much stronger position when you retire.

Not every plan has a Roth component; they first became available in 2006. I was able to take advantage of one of the first 401(k) plans, which were introduced in 1981 (and helped install the second workplace 401(k) in northwest Pennsylvania). My employer was wise enough to listen to the innovative Benefits Consultant Ted Benna, who is widely credited as the inventor of the 401(k). Of course, I had no idea then how this vehicle would grow in importance to so many of us. It has given me a historical perspective that I can call on as I work with clients along with my colleagues at HBKS Wealth Advisors.

You might ask, did I switch my ongoing annual contributions to Roth? Yes, earlier this year, and I'm happy I did. I think you will be too.

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