SHOULD INVESTORS FOCUS SAVING IN PRE- OR AFTER-TAX RETIREMENT ACCOUNTS?

by: Tim Sullivan, CFP®, EA

A common dilemma faced by individuals saving for retirement is how to allocate money between available pre-tax accounts like a 401(k) or traditional IRA and after-tax accounts such as a ROTH IRA or ROTH 401(k). Here are some points to consider if weighing this decision. When choosing between funding an available pre-tax account or a ROTH option, an investor is essentially declaring whether they believe their marginal tax rate (the tax rate on the last dollar earned) is higher or lower today than what it will be when they retire. If the tax rate is the same at both the time they contribute the money and the time they withdraw the money, the outcome is ultimately equal.

For example, consider Lisa, an investor with a marginal tax rate of 24%, who believes she will have the same tax rate in retirement. If she plans to save $10,000 this year, she could put the full amount in her pre-tax 401(k) now, or she could pay the taxes due and invest $7,600 into the ROTH option in the same plan. After 20 years with a 7% growth rate, she would retire with $38,697 in the pre-tax 401(k) or $29,410 in the ROTH. If she withdraws the money form the pre-tax 401(k) and pays taxes on it in retirement, she will have $29,410, the exact same amount that she has in the tax-free ROTH account. If Lisa believes she will end up in a high tax bracket in retirement, then the ROTH option could be the best decision. However, if she thinks she will be in a lower tax bracket when she retires, utilizing the pre-tax 401(k) contributions would put her many dollars ahead.

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Intuitively it should make sense that most people are not in a higher tax bracket once the paychecks stop. There are exceptions to this, of course. A University of Missouri employee with 35 years of credit on the old pension system (new employee eligibility ended in 2012), who has contributed to Social Security and saved a healthy amount in their retirement accounts, could see their marginal tax rate increase when pensions, Social Security, and required minimum distributions (RMDs) are all being collected. However, pensions like what the university once offered are becoming less and less common. Even for retirees with pensions there are often years between the time they retire and the time they start collecting from Social Security and/or pensions where withdrawals from tax-deferred accounts can be done in lower tax brackets.

Consider a client who retired at age 60 with $500,000 in an IRA. In her specific situation, delaying Social Security until age 67 and delaying her pension until age 70 are optimal cash flow strategies. As such, she can withdrawal $50,000 per year from her IRA to supplement her current cash flow needs and pay taxes at a 0% and 12% marginal tax rate. Given that most of her retirement saving was done while in a 25% marginal tax bracket, she is thousands of dollars ahead having utilized her pre-tax options during her working years.

The argument for using ROTH accounts regardless of someone's marginal tax rate typically sound something like this: "Well, tax rates are low today and will certainly be higher in the future, so you should use the ROTH." For people in very low tax brackets, that may be true. However, most high-income earners will find themselves in a lower tax bracket when retired.

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Take a married couple earning $600,000 per year today. If we assume $100,000 in investment and Social Security income at retirement, they will need $12.8 million in pre-tax retirement accounts to create RMDs of $500,000 at age 72. For even super-savers, this is an unlikely total. If they were to achieve this level of saving, they would still be withdrawing much of that RMD at a lower tax brackets. When it comes to saving tax money, the old saying "A bird in the hand is worth two in the bush" are words to live by. While there is no bright line in determining when to contribute to pre-tax or ROTH accounts, think carefully before giving up tax savings today based on what could happen in the future.

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