BUSINESS

Milwaukee Journal Sentinel
JSOnline.com

Sunday,
June 30, 2019

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Roth 401(k) could be a better choice

401(k) ADVISER
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The Roth 401(k) account was first made available nearly 15 years ago. Today, how one works is still a mystery to most and only 11% of those eligible use one, according to Vanguard's How America Saves 2019 edition. This in the face of overwhelming evidence of the benefits of Roth for certain types of savers.

Clearly, foregoing an up-front tax deduction goes against everything we're taught in Financial Planning 101. But for many, waiting to collect the meaningfully larger tax benefits of Roth in retirement should lead to a better outcome.

Over the years, we've heard all kinds of reasons why people don't use Roth. Some mistakenly think because there are income limits on those who can contribute to a Roth IRA, those same limits apply to a Roth 401(k). Others are skeptics and believe it's safer to capture some form of tax break today, no matter how small, than to wait for one that is promised down the road, no matter how potentially large.

Whatever the reason, experts agree that saving in a Roth account is likely better for many 401(k) participants today. The fact that so few take advantage means for many it's time to revisit this issue.

Let's review the tax advantages offered by a Roth 401(k) account and those who should seriously consider switching to a Roth 401(k) account.

Under 40

Most younger workers are well-suited to a Roth 401(k) account because they're early in their career and still in a low tax bracket. This makes the loss of an up-front tax deduction less of a sacrifice and easier to live without. Furthermore, younger workers have a long investment time horizon. The biggest benefit a Roth account offers is that all your earnings and your initial investment are forever free from taxation if withdrawn in retirement and after at least five years after the account was started.

Legendary stories abound of tech entrepreneurs purchasing pre-IPO shares in a Roth account, only to see their value skyrocket creating a huge tax-free windfall to be enjoyed in retirement.

Tax diversifiers

When your employer contributes matching, profit sharing or non-discretionary dollars to your 401(k) account, they are required to use pre-tax dollars. Therefore, the vast majority of 401(k) participants will build a substantial pool of pre-tax dollars that will be subject to ordinary income taxation upon their withdrawal in retirement. To protect against the risk of higher tax rates in retirement, and to allow for income tax planning in retirement, contributing dollars to a Roth 401(k) account can be a smart tax diversification strategy.

Maximum savers

While few can afford to save the maximum in their 401(k) plan, which is $19,000 in 2019, for those in the top tax bracket, saving $19,000 after-tax is equivalent to saving more than $24,000 pre-tax. Anyone looking to maximize their annual retirement savings via their employer's payroll deduction retirement savings plan should use a Roth account.

Estate planners

Because the assets in a Roth account have already been taxed, the IRS promises your contributions, and all their future earnings, will not be taxed again. Therefore, the current rule mandating Required Minimum Distributions, beginning at age 70½ from traditional 401(k) accounts, does not apply to Roth assets if you roll over your account into a Roth IRA before age 70½.

This means if you are fortunate enough to not need your retirement savings right away in retirement, having assets in a Roth account allows you to keep this money sheltered and compounding tax-free for as long as you desire.

This tax-free distribution status also carries over to Roth assets left to your beneficiaries. Any Roth assets passed along after your death are inherited without income taxes being owed by your beneficiaries.

Not for everyone

Those who are in a high tax bracket, those who expect to be in a meaningfully lower tax bracket when they retire and those who have a limited time to save before withdrawing their savings should focus on pre-tax traditional 401(k) contributions. Lowering your taxable income currently will allow you to put more away for retirement, which is likely to compensate you for the taxes you will pay when you begin to withdraw your retirement savings.

Some financial planning experts speculate the best explanation for the lack of utilization of Roth 401(k) is that many 401(k) service providers prefer you don't use Roth because it's likely to lower the amount you save and therefore the fees they collect.

All the more reason to read columns like this one and gain an independent opinion before deciding what's best for you.

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