

TRADITIONAL 401(k) VS. ROTH 401(k)

Retirement savings plans can be confusing. If you're in the working world, chances are that your employer offers a 401(k) with two options: a traditional 401(k) option and a Roth 401(k) option. Get to know the differences so you can decide which option may be right for you.

Let's start with the basics

Contribution limits: For the 2020 tax year, the maximum that can be contributed to a 401(k) savings plan is \$19,500. If you are age 50 or older, the IRS allows an additional \$6,500 as a catch-up contribution.¹ These figures are an aggregate number and can be split between traditional and Roth 401(k) dollars. Combined contributions to a traditional 401(k) and Roth 401(k) cannot exceed \$19,500 or \$26,000 if aged 50 or older.

Traditional 401(k): This is the employer-sponsored savings plan most of us are familiar with. Under a traditional 401(k), contributions are made pre-tax thereby reducing your taxable income. Taxes are paid in future years when you take distributions; either when you elect to take distributions or upon turning 72 when you have to take a required minimum distribution, per IRS rules.

Roth 401(k): Contributions to this savings plan are made after-tax and therefore will not reduce your taxable income. Because your contributions are made after-tax, the money in your Roth 401(k) grows tax free. This means you will not pay any taxes on distributions. After you retire, you may roll your Roth 401(k) to a Roth IRA. Doing so will eliminate the IRS requirement to take distributions at age 72.

Certain conditions must be met to qualify for tax-free and penalty-free distributions:



The Roth 401(k) account must be open for five years. In addition, one of the following conditions needs to be met for tax-free and penalty-free distributions:

1. You have reached age 59½
2. You are disabled
3. First-time home purchase
4. Death

So which one do you choose?

The answer comes down to taxes. When is it most advantageous for you to defer income versus pay income tax? Now or later in life?

The general rule is, the longer you have until you retire, and if you expect your tax rate to be higher in retirement, the Roth 401(k) option is considered to be more beneficial.

A traditional 401(k) may be the best option if you're in your peak earning/highest earning years and your goal is to reduce your current tax bill.

Can you choose both?

Yes (if your plan allows). Choosing to make contributions to both a traditional 401(k) and a Roth 401(k) may be the most prudent course of action. Diversifying your taxes is just as important as diversifying your investments.

This strategy will allow you to adjust your contributions each year depending on expected tax rates and changes in income.

This decision, like most financial decisions, is not straightforward. Look for an advisor who will work with your CPA and understands your tax situation, both current and forecasted. After your advisor understands your financial picture and goals, he or she can help you create a financial strategy that allows you to save for your family's future.

¹ "401(k) Contribution Limit Increases" [irs.gov. https://bit.ly/2OqT0wg](https://irs.gov.https://bit.ly/2OqT0wg)

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