RETIREMENT

Should You Use The Roth Retirement Savings Option?

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We've had Roth options in 401(k) plans for some time now and Roth IRAs even longer. This has given people a chance to discover how Roths can offer savings advantages for retirement and other financial needs.

The Roth option has usually been seen from the perspective of retirement alone.

“The Roth IRA can payoff in retirement as it provides you a source of tax-free income,” says Herman (Tommy) Thompson, Jr., a Financial Planner with Innovative Financial Group in Atlanta. “The traditional 401(k) and the traditional IRA payoff right now. Traditional contributions get a current year federal and state tax deduction which makes it easier to save. The Roth doesn’t get a tax deduction. Additionally, some states (like Georgia) have rules that lower or eliminate the state tax on retirement distributions. The Roth 401(k) and Roth IRA just aren’t as attractive in these states.”

The decision between using a traditional tax-deferred retirement savings vehicle and its Roth counterpart may seem complicated, but the math is straightforward.

“If tax brackets remain constant over a long period of time, the assets available for distribution on an after-tax basis will be identical under a Roth IRA and a traditional IRA,” says Marcia S. Wagner, President/Founder of The Wagner Law Group in Boston. “A traditional deductible IRA will provide better results than a Roth IRA if the individual’s tax rate at the time of distribution will be lower than it was during the contribution phase.”

For several years now, America has been in a low tax rate environment. Many feel this won’t last. The math tells you the Roth should be the preferred retirement savings alternative. There are, however, very good reasons why fewer people than you’d expect are using Roths.

The most obvious reason is they can’t.

“Couples married and filing jointly often do not qualify since they exceed the income limitations ($214,000 in 2022),” says Daniel G. Dolan, Principal at TFB Advisors, LLC in Overland Park, Kansas. “Roth 401(k)s have no income limitations and are now available in

70% of employer sponsored plans. However, only 18% of participants contribute after-tax dollars to their 401(k). As a newer and less understood option, it is vastly underutilized."

Yet, there's also an obvious reason why you don't see as many employees using Roth 401(k) plans.

"Plans which use a pretax automatic enrollment will usually see lower Roth utilization," says Kit Gleason, VP/Senior Relationship Manager, First Bank & Trust, Sioux Falls, South Dakota. "The feature overcomes participant inertia when it comes to the savings decision, but the same participant inertia applies when it comes to making the pretax versus Roth choice."

The default into the tax-deferred alternative represents a legacy way of thinking on the part of those who design 401(k) plans. Today's employee demographic challenges this continuing strategy.

Jack Towarnicky, Of Counsel at Koehler Fitzgerald, LLC in Powell, Ohio, says, "More than 95% of 401(k) plans with automatic features default employees into pre-tax contributions, even though: 1) Most new hires are in as low of a marginal income tax bracket as they will experience during their working careers; 2) Most non-participants (if you 'back sweep') may be in as low of a marginal income tax bracket as they will ever see for the rest of their lives; and, perhaps most importantly, 3) The median tenure of American workers continues to be less than five years, so where separation occurs prior to age 55 (or age 59½), a distribution of pre-tax contributions would not only be subject to marginal income tax rates (federal and state) but also, potentially, to a 10% excise tax for early withdrawal."

Many plans have yet to add in-plan Roth conversion features. Towarnicky attributes this to "executives, especially those who live in states without income taxes or those where the state income tax marginal rates are low, haven't re-considered the value of using a Roth."

Towarnicky suggests four reasons why adding a Roth option might make sense:

- The opportunity to leverage current low marginal income tax rates.
- Conversion to Roth IRA avoids the application of required minimum distribution rules.
- For an executive in a 33% marginal income tax bracket who is contributing at the 402(g) regular and 414(v) catch-up maximums in 2022 (that would be $27,000), contributing the same dollar amount on a Roth basis would be the equivalent of contributing $40,300 on a pre-tax basis.
- Distributions of Roth assets after retirement do not raise Modified Adjusted Gross Income (MAGI) for Income Related Monthly Adjustment Account (IRMAA) for the purposes of Medicare Part B and Part D premiums.

Despite this, even when the Roth option is available (whether through a 401(k) or the IRA), retirement savers simply aren't accessing it. To some extent, and particularly among older savers who have been ingrained with the priority of saving taxes today, the Roth simply doesn't offer what they're looking for.

Retirement savers are attracted to "immediate gratification," says R.L. "Dick" Billings, Senior Document and Compliance Specialist for PCS Retirement in Jefferson, South Dakota. "They can better understand the tax exclusion up-front, but not the earnings exclusion many years down the road. Roths are generally best for young people but thinking about the value of such income exclusion 40 years down the road is difficult to quantify."

Assuming tax rates will be increasing, the Roth option is the one that makes the most sense. Still, people like the feeling of deferring taxes now.

"Many people avoid a Roth option despite qualifying for one because contributing to a traditional option helps reduce taxable income, which may help to save a person money when their tax bill is due," says Erik Wright, Owner of New Horizon Home Buyers in Chattanooga, Tennessee.

"This is a rather short-sighted approach that can leave a portfolio too heavily weighted towards tax-deferred investments in the long term," says Ryan McKeown, Senior Vice President Financial Advisor at Wealth Enhancement Group in Mankato, Minnesota. "A lot of people don't even realize they have a Roth 401(k) option available in their plan. It is an education issue."

It's important to recognize that short-term circumstances can make it impossible to opt for the long-term choice.

"With so many workers living paycheck to paycheck," says Kenneth Dean, Senior Director of Financial Planning at Winthrop Wealth in Boston, "they prefer the tax savings today instead of funding the

Roth option with after-tax contributions as it leaves less for everyday living expenses."

There are many good reasons to use a Roth retirement savings option. There are also situations when it's reasonable to use a tax-deferred retirement savings account instead. Which choice best fits your circumstances?

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