Buckingham
RETIREMENT SOLUTIONS

401(k) Salary Deferrals

Traditional vs. Roth

If you are eligible to participate in a 401(k) plan, the plan most likely offers two option for your Salary Deferral contributions – Traditional (pre-tax) Deferrals or Roth (after-tax) Deferrals. Traditionally, deferrals are made on a pre-tax basis, essentially reducing your taxable income for the year. When you elect the Roth option, the funds withheld from your pay are taxed prior to deposit into the plan. To find out if your plan includes a Roth feature, check your Summary Plan Description or ask an HR representative.

There are advantages and disadvantages of each option, and you should consider all aspects when deciding which tax strategy is appropriate for your situation. Both types of deferrals are limited by the IRS to a specific dollar amount, set annually (and indexed for inflation).

Traditional Deferrals

PROS

- Reduces current taxable income
- Lower tax obligation may increase take-home pay available for deferral
- Defer taxes on contributions and earnings

CONS

- Distributions taxed as ordinary income
- Tax burden realized at retirement

Roth Deferrals

PROS

- Contributions distributed tax-free
- Qualified Earnings are tax-free

CONS

- Contributions made from after-tax compensation
- Tax burden realized today

Summary

There are several factors to consider when choosing which is option is most appropriate for you. Consider your potential tax rates. If your tax rate at retirement is expected to be lower, then perhaps deferring taxation may be more beneficial. However, if tax rates are expected to be higher, then paying the taxes now might be less costly. For most workers, as time passes salaries increase and the taxpayer enters higher tax brackets. Therefore, the results of this analysis may change over time.

Also consider how the level of taxable income could affect other benefits, such as social security, financial aid, tax considerations, and your overall financial disposition. Beyond a certain income threshold, you are no longer able to contribute to a Roth IRA. In this case, the Roth option in the 401(k) may be a viable alternative. Finally, envision your retirement, and consider your distribution preferences. You may prefer to pay taxes while you are working and can afford to do so rather than pay taxes during retirement from your limited resources. If the purpose of the funds is for gifting, you may also wish to leave tax-free amounts to heirs.

The material provided is for general information and education purposes only and does not constitute investment, legal, or tax advice. Individuals should seek independent tax advice from a tax professional prior to implementing a new strategy.