Trust Company
of Illinois

January 2019

# DECISIONS, DECISIONS: CHOOSING AMONG RETIREMENT PLAN CONTRIBUTION TYPES

If your employer-sponsored 401(k) or 403(b) plan offers pre-tax and/or Roth contributions, which should you choose?

## PRE-TAX: FOR THOSE WHO WANT LOWER TAXES NOW

With pre-tax contributions, the money is deducted from your paycheck before taxes, which helps reduce your taxable income and the amount of taxes you pay now. Consider the following hypothetical example:

Keira earns $2,000 every two weeks before taxes. If she contributes nothing to her retirement plan on a pre-tax basis, the amount of her pay that will be subject to income taxes will be the full $2,000. If she was in the 25% federal tax bracket, she would pay $500 in federal income taxes, reducing her take-home pay to $1,500.

On the other hand, if she contributes 10% of her income to the plan on a pre-tax basis — or $200 — she would reduce the amount of her taxable pay to $1,800. That would reduce the amount of taxes to $450.

After accounting for both federal taxes and her plan contribution, Keira's take-home pay would be $1,350. The bottom line? Keira would be able to invest $200 toward her future by reducing her take-home pay by just $150.

In addition, any earnings made on pre-tax contributions grow on a tax-deferred basis. That means you don't have to pay taxes on any gains each year. However, any money withdrawn from a tax-deferred account is subject to ordinary income taxes. If the withdrawal takes place prior to age 59½ (or in some cases, age 50 or 55), you may be subject to a 10% penalty on the total amount of the distribution.

## ROTH: FOR THOSE WHO PREFER TAX-FREE INCOME LATER

On the other hand, contributing to a Roth account offers different benefits. Roth contributions are considered "after-tax," so you won't reduce the amount of current income subject to taxes. But qualified distributions down the road will be tax-free.

A qualified Roth distribution is one that occurs:

- After a five-year holding period and
- Upon death, disability, or reaching age 59½

Distributions of Roth contributions are always tax-free because they were made on an after-tax basis. And distributions of earnings on those contributions are tax-free as long as they're qualified. Nonqualified distributions of earnings are subject to regular income taxes and a possible 10% penalty tax. If,

at some point, you need to take a nonqualified withdrawal from a Roth account — only the pro-rata portion of the total amount representing earnings will be taxable.

Keep in mind that tapping your account before retirement defeats its purpose. If you need money in a pinch, try to exhaust all other possibilities before taking a distribution. Always bear in mind that the most important benefit of a Roth account is the opportunity to build a nest egg of tax-free income for retirement.

## WHICH TO CHOOSE?

If your plan offers both pre-tax and Roth contributions, the general rule is to consider whether you will benefit more from the tax break today than you would in retirement. Specifically, if you think you'll be in a higher tax bracket in retirement, Roth contributions may be more beneficial in the long run.

In retirement, you may benefit from the flexibility of taking yearly income from either the taxable balance and/or the tax-free Roth balance.

Your plan may offer the opportunity to transfer or convert pre-tax savings to Roth savings. You will need to pay income taxes on the amount transferred in the year of the transfer, and then you'll get Roth treatment of those dollars going forward.

Also, strive for contributing at least enough to receive any employer match that may be offered. Matching contributions represent money that your employer offers to help you pursue your savings goal. If you don't contribute enough to take advantage of the full amount of the match, you are essentially turning down free money.

Keep in mind that employer matching contributions are made on a pre-tax basis. Distributions representing employer matching dollars and related earnings will always be subject to regular income taxes and a potential 10% tax penalty if distributed prior to age 59½ (or, in some cases, age 50 or 55).

For more information specific to your tax situation, consult a qualified tax professional. (Working with a tax professional cannot guarantee financial success.) ■

Investment advisory services provided through TC Wealth Partners, LLC, an investment advisor registered with the U.S. Securities and Exchange Commission. Trust services and retirement plan services are provided by the Trust Company of Illinois, a trust company chartered by the Illinois Department of Financial and Professional Regulation. Past performance is not indicative of future results.