Money Matters

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Skloff Financial Group Question of the Month
By Aaron Skloff, AIF, CFA, MBA

Q: We are evaluating whether to make pre-tax contributions or Roth contributions to our retirement accounts, including 401(k)s, 403(b)s, 457(b)s and IRAs. Which is a better choice for contributions and withdrawals?

The Problem – Determining if Pre-tax Contributions or Roth Contributions Are Better
Withdrawals of pre-tax retirement account contributions are subject to income taxes. Withdrawals of Roth retirement account contributions are tax free. Since tax free withdrawals are better than taxable withdrawals, Roth contributions must be the simple answer to the question - right? Not so fast.

The Solution – Understanding the Advantages and Disadvantages of Pre-tax and Roth Contributions and Withdrawals
Both types of contributions have advantages and disadvantages upon contribution and withdrawal. Let's examine them below.

Pre-Tax Contributions
Advantages. Pre-tax contributions defer federal and state income taxes. For example: If you are in the 24% federal and 6% state marginal income tax brackets, every $1.00 of **pre-tax contributions** defers $0.30 of taxes, or **30%**. Pre-tax contributions can reduce your taxable income and marginal income tax bracket. With a lower income you can qualify for a Roth IRA, realize capital gains at a 0% or 15% capital gains rate, etc.

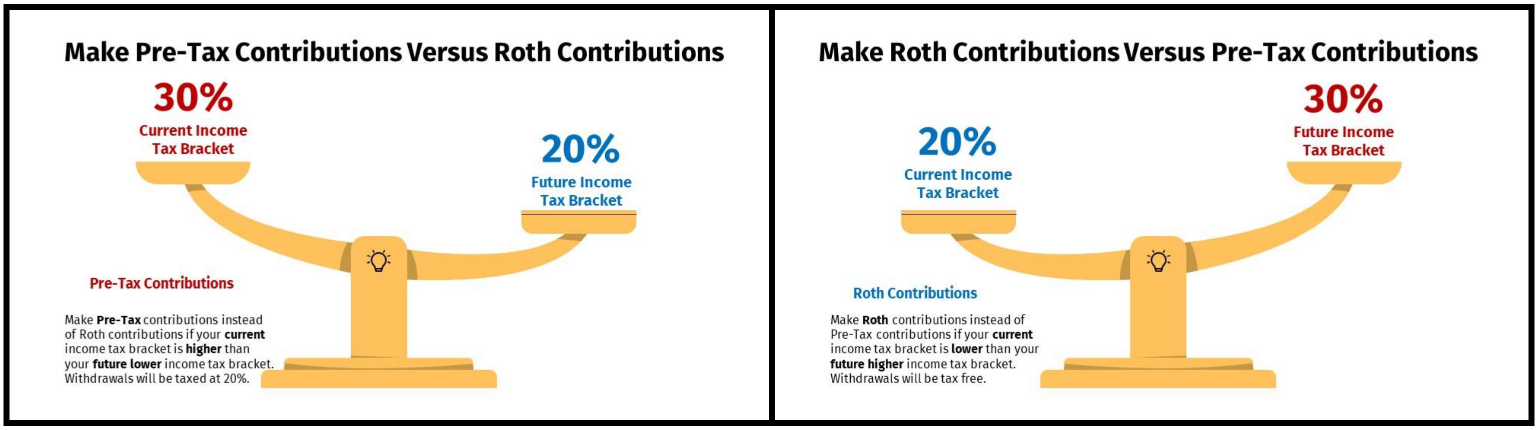
Disadvantages. Pre-tax withdrawals are taxed at your marginal federal and state income tax brackets. A disadvantageous example: If you will be in the 32% federal and 8% state marginal income tax brackets when you take withdrawals in retirement, every $1.00 of pre-tax withdrawals will be subject to $0.40 of taxes, or 40%. A common example: If you will be in the 12% federal and 8% state marginal income tax brackets when you take withdrawals in retirement, every $1.00 of **pre-tax withdrawals** will be only be subject to $0.20 of taxes, or **20%**.

Strategy. Make **pre-tax** contributions instead of Roth contributions if your **current** income tax bracket is **higher** than your future income tax bracket. Contributing at a 30% pre-tax rate and withdrawing at a 20% rate creates a **10% tax arbitrage**. See the chart below.

Roth Contributions
Advantages. Roth contributions are subject to federal and state income taxes. For example: If you are in the 12% federal and 8% state marginal income brackets, every $1.00 of **Roth contributions** is subject to $0.20 of taxes, or **20%**. Lower income earners, such as younger employees, can utilize their full 'low' marginal income tax bracket as an arbitrage to a higher income tax bracket on withdrawals in retirement.

Disadvantages. Roth withdrawals are tax free. A disadvantageous example: If you will be in the 10% federal and 5% state marginal income tax brackets when you take withdrawals in retirement, every $1.00 of Roth withdrawals will only avoid only $0.15 of taxes, or **15%**. A common example: If you will be in the 22% federal and 8% state marginal income tax brackets when you take withdrawals in retirement, every $1.00 of **Roth withdrawals** will avoid $0.30 of taxes, or **30%**.

Strategy. Make **Roth** contributions instead of pre-tax contributions if your **current** income tax bracket is **lower** than your future income bracket. Contributing at a 20% after tax rate and withdrawing, while avoiding a 30% rate creates a **10% tax arbitrage**. See the chart below.



Action Steps
Realize tax arbitrage by deferring taxes with **pre-tax** contributions if your **current** income tax rate is **higher** than your future income tax rate. Realize tax arbitrage by paying taxes today with **Roth** contributions if your **future** income tax rate is **higher** than your current income tax rate. Work closely with your Registered Investment Adviser (RIA) to reduce your taxes, and grow and preserve your wealth.

Aaron Skloff, Accredited Investment Fiduciary (AIF), Chartered Financial Analyst (CFA), Master of Business Administration (MBA) is CEO of Skloff Financial Group, a Registered Investment Advisory firm specializing in financial planning, investment management and benefits for small to middle sized companies. He can be contacted at www.skloff.com or 908-464-3060.