Money Matters

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

Q: We read 'Pre-tax Versus Roth Employer Contributions to Retirement Accounts – Which Is Better?' Part 1. Can you give us examples of contributions today versus withdrawals in the future?

The Problem – Tax-free Roth Employer Withdrawals Always Sound Better Than Taxable Withdrawals on the Surface
Even if you receive a tax benefit today through pre-tax employer contributions, you are simply creating an even larger future tax upon withdrawal - right? Tax-free employer withdrawals just inherently seem better on the surface. Like an audience member at a magic show, don't let the magician trick you into seeing what you want to believe versus reality.

The Solution – A Side by Side Comparison of Employer Contributions Today and Withdrawals in the Future
Accounting for taxes today and in the future reveals how a future tax obligation may be more than offset by a tax benefit today.

Current Income Tax Bracket of 30% and Future Income Tax Bracket of 20% Example
Pre-Tax Employer Contributions: All of Your Employer Contributions are Invested. Pre-tax employer contributions defer federal and state income taxes. For example: If you are in the 30% combined federal and state marginal income tax brackets, every $1.00 of **pre-tax contributions** defers $0.30 of taxes, or **30%**. If your employer contributes $10,000 to your 401(k), 403(b) or 457(b) plan, the full $10,000 is contributed because the taxes are deferred. If your employer's contribution is invested and grows at 7% per year, after 40 years it will be worth $149,745. If you will be in the 20% combined federal and state marginal income tax brackets when you take employer withdrawals in retirement, every $1.00 of **pre-tax withdrawals** will be only be subject to $0.20 of taxes, or **20%**. After taxes, your net withdrawal is $119,796. See below.
Roth Employer Contributions: Only Your Employer Net of Tax Contributions are Invested. Roth employer contributions are subject to federal and state income taxes. For example: If you are in the 30% combined federal and state marginal income tax brackets, every $1.00 of gross employer contributions is subject to $0.30 of taxes, or **30%**. If your employer gross contributes $10,000 to your 401(k), 403(b) or 457(b) plan, only $7,000 is contributed because you pay taxes today. If your employer's net contribution is invested and grows at 7% per year, after 40 years it will be worth $104,821. Since Roth employer withdrawals are tax free, your net withdrawal is $104,821. See below.

Current Income Tax Bracket of 20% and Future Income Tax Bracket of 30% Example
Pre-Tax Employer Contributions: All of Your Employer Contributions are Invested. Pre-tax employer contributions defer federal and state income taxes. For example: If you are in the 20% combined federal and state marginal income tax brackets, every $1.00 of **pre-tax contributions** defers $0.20 of taxes, or **20%**. If your employer contributes $10,000 to your 401(k), 403(b) or 457(b) plan, the full $10,000 is contributed because the taxes are deferred. If your employer's contribution is invested and grows at 7% per year, after 40 years it will be worth $149,745. If you will be in the 30% combined federal and state marginal income tax brackets when you take withdrawals in retirement, every $1.00 of **pre-tax withdrawals** will be subject to $0.30 of taxes, or **30%**. After taxes, your net withdrawal is $104,821. See below.
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Current Income Tax Bracket 30%, Future Income Tax Bracket 20%		
Pre-tax Employer Contributions and Withdrawals	Taxes	Roth Employer Contributions and Withdrawals
$10,000 $0	Gross Contribution 30% Federal + State Income Taxes	$10,000 ($3,000)
$10,000	Net Contribution	$7,000
$149,745 ($29,949)	Value After 7% Growth for 40 Years 20% Federal + State Income Taxes	$104,821 $0
$119,796	Net Withdrawal	$104,821

Current Income Tax Bracket 20%, Future Income Tax Bracket 30%		
Pre-tax Employer Contributions and Withdrawals	Taxes	Roth Employer Contributions and Withdrawals
$10,000 $0	Gross Contribution 20% Federal + State Income Taxes	$10,000 ($2,000)
$10,000	Net Contribution	$8,000
$149,745 ($44,923)	Value After 7% Growth for 40 Years 30% Federal + State Income Taxes	$119,796 $0
$104,821	Net Withdrawal	$119,796

Action Steps
Defer taxes with **pre-tax** employer contributions if your **current** income tax rate is **higher** than your future income tax rate. Pay taxes today with **Roth** employer 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.

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