Money Matters

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Skloff Financial Group Question of the Month
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Q: We read 'Pre-tax Versus Roth Contributions to Retirement Accounts – Which Is Better?' Part 1 and Part 2 and 'Does Your State Tax Pre-Tax Contributions to Retirement Accounts?' Part 1. For state income tax purposes, which is more advantageous when contributing to and withdrawing from retirement accounts: pre-tax or Roth contributions?

The Problem – Determining if Pre-tax Contributions or Roth Contributions Are Better
Contributions to pre-tax retirement accounts are subject to state income taxes in some states. Withdrawals of pre-tax retirement account contributions are subject to state income taxes in some states. 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 income taxes and state income taxes in some states, but are taxable in some states. For example: If you are in the 6% state (marginal) income tax rate, every $1.00 of **pre-tax contribution**s defers $0.06 of taxes in some states.

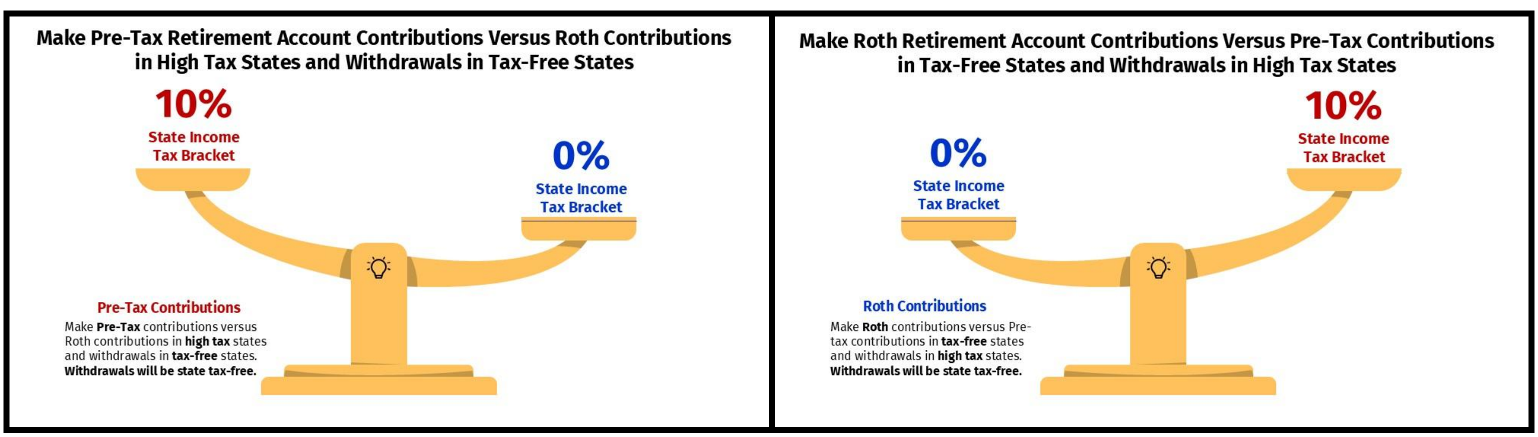
Disadvantages. Pre-tax withdrawals are taxed at your state (marginal) income tax rate in some states. A disadvantageous example: If you will be in the 12% state (marginal) income tax rate when you take withdrawals in retirement, every $1.00 of pre-tax withdrawals will be subject to $0.12 of state income taxes. A common example: If you will be in the 10% state (marginal) income tax rate when you take withdrawals in retirement, every $1.00 of **pre-tax withdrawals** will only be subject to $0.10 of taxes.

Strategy. Make **pre-tax** contributions instead of Roth contributions if your **current** state (marginal) income rate is **higher** than your future state (marginal) income tax rate. Contributing at a 10% pre-tax rate and withdrawing at a 0% rate creates a **10% tax arbitrage**. See the chart below.

Roth Contributions
Advantages. Roth contributions are subject to federal income taxes and state income taxes in some states, but are tax-free in some states. For example: If you are in the 12% state (marginal) income rate, every $1.00 of **Roth contributions** is subject to $0.12 of taxes. Lower income earners, such as younger employees, can utilize their full 'low' state (marginal) income tax rate as an arbitrage to a higher state (marginal) income tax rate on withdrawals in retirement.

Disadvantages. Roth withdrawals are tax-free. A disadvantageous example: If you will be in the 2% state (marginal) income tax rate when you take withdrawals in retirement, every $1.00 of Roth withdrawals will only avoid $0.02 of taxes. A common example: If you will be in the 10% state (marginal) income tax rate when you take withdrawals in retirement, every $1.00 of **Roth withdrawals** will avoid $0.10 of taxes.

Strategy. Make **Roth** contributions instead of pre-tax contributions if your **current** state (marginal) income tax bracket is **lower** than your future state (marginal) income tax rate. Contributing at a 0% tax-free state (marginal) income tax rate and withdrawing, while avoiding a 10% state (marginal) income tax 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.

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