

Some More Thoughts on Roth 401(k) Contributions

As a general rule, Roth accounts are for people who are not in their peak earnings years, and tax-deferred accounts are for those in their peak earnings years. There are lots of exceptions to this general rule, of course. One of the most well-known ones is the Backdoor Roth IRA. But in that case, you're really comparing a Roth account to a taxable account. Of course the Roth wins hands down.

In a 401(k), you are allowed to make the "employee contribution" (\$18K for those under 50, \$24K for those over 50) either tax-deferred or Roth. One of The Finance Buff's [most famous posts](#) was written shortly after this option came into being, showing that the Roth option was a poor choice for most people, although even he recently acknowledged [there are some exceptions](#). I've written on this subject before as well. Today, I'm going to talk about some other exceptions and give you a few things to think about if you have a Roth option in your 401(k).

Uncertainty and Tax Diversification

When you're not sure what to do in a financial situation without a clear answer, it can be a good idea to hedge your bets by splitting the difference. If you have a typical 401(k)/Profit-sharing plan (\$52K limit in 2014 increasing to \$53K in 2015) you still have a \$34,500 tax-deferred contribution, even if you put the entire \$17.5K employee contribution into a Roth account. Combining that with \$11K

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(\$12K in 2015) in personal and spousal backdoor Roth IRAs, you get a total of \$28.5K. Since Uncle Sam probably owns a quarter or more of the pre-tax employer contribution, these amounts are roughly equivalent, ~50% in each type of account.

Roth vs Tax-deferred + Taxable



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Assuming he's actually maxing the 401(k) out, in order to save the equivalent after-tax amount of money, an investor who preferentially used a pre-tax account would have to also make a taxable investment. For example, an investor with a 40% marginal tax rate could either put \$17.5K into a Roth 401(k), or put \$17.5K into a tax-deferred 401(k) plus $\$17.5K \times 0.40 = \$7K$ into a taxable account. Of course, that taxable account is going to grow a little slower than the Roth 401(k) due to the tax drag. So even if you're contributing and withdrawing at the exact same tax rates, the Roth 401(k) is going to be a better option. In effect, you have a larger retirement account. This is particularly important for high income employees who may not have a lot of retirement account options.

Super Savers Beware

As [I've written before](#), you don't want to have too large of a tax-deferred account, at least if a larger Roth account is an option. This isn't an issue for most docs, who are dramatically undersaving, started too late, and are getting

poor returns. The typical doc probably ought to be making all tax-deferred contributions. Same with a doc who plans to retire very early (with a smaller tax-deferred nest egg or at least many years with which to make withdrawals or do Roth conversions). But if you're a super-saver, have lots of tax-deferred options, are young, and plan to work a relatively full career, you might want to do a little more Roth. For example, I'm deferring a six figure amount this year. If I keep that up for 20 more years, I'm going to have a monstrously-sized tax-deferred account.

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Consider the Required Minimum Distributions (RMD) on a \$10 Million tax-deferred IRA (\$106K a year for 35 years growing at 5% real) when you hit age 70 1/2. That first year the RMD is 3.6% of the account, or \$360K. Combined with Social Security, and possibly rental real estate or other taxable income, that type of RMD is going to get you into a high tax bracket. By age 80, it's 5.3%, and if that account kept up with inflation despite the withdrawals, it could be \$530K a year, well into the top tax bracket even for married folks not including other income. A larger Roth would be very useful in that type of situation.

What do you think? Are you making Roth 401(k) contributions despite being in your peak earnings years? Why or why not? Comment below!