PERSONAL FINANCE

Choosing between pre-tax and Roth 401(k) plans can be much trickier than you think

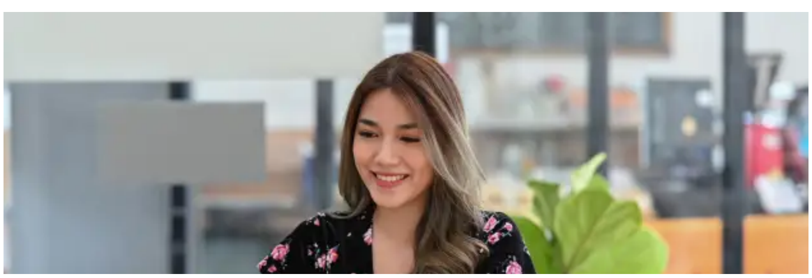
PUBLISHED SAT, MAY 28 2022•9:00 AM EDT

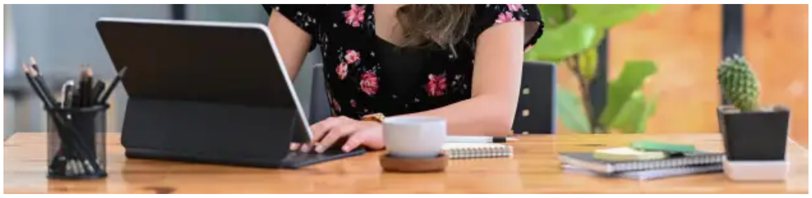
Kate Dore, CFP®
@KATEDORE

SHARE

KEY POINTS

- Choosing between pre-tax and Roth 401(k) contributions may be trickier than you expect, according to financial experts.
- Pre-tax 401(k) deposits reduce your adjusted gross income, and the money grows tax-deferred.
- By contrast, Roth 401(k) contributions don't provide an upfront write-off, but earnings are tax-free.
- However, there may be other tax trade-offs, so you'll need to weigh the pros and cons before diverting funds.





Prathanchorruangsak | Istock | Getty Images

Whether you're a current employee or changing jobs, you may need to choose between pre-tax and Roth 401(k) contributions, and it may be trickier than you expect.

Here's the difference: Pre-tax 401(k) deposits reduce your adjusted gross income, and the money grows tax-deferred, meaning you'll pay levies on withdrawals. By contrast, Roth 401(k) contributions don't provide an upfront write-off, but earnings are tax-free.

However, there may be other tax trade-offs, so you'll need to weigh the pros and cons before diverting funds, financial experts say.

More from Personal Finance:
[White House tries to figure out which student debt to forgive]
[There's an 'un-retirement' trend amid this hot job market]
[How to beat back rising prices with Memorial Day deals]

Roughly 86% of 401(k) plans offered a Roth account in 2020, up from 75% in 2019, according to the Plan Sponsor Council of America.

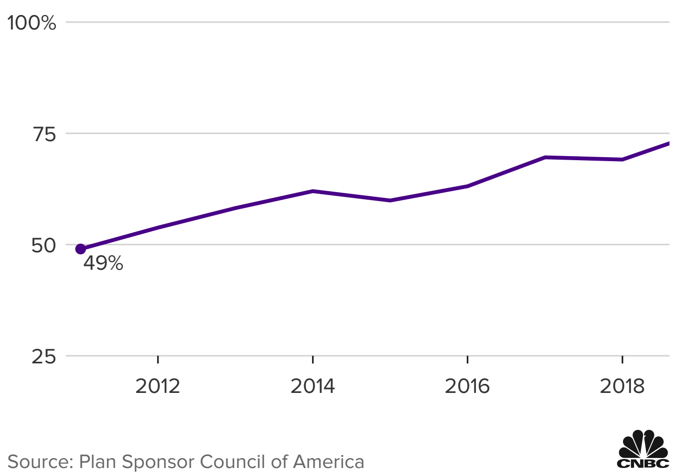
"In general, the goal is to take deductions at a higher tax rate and distributions at a lower one," said certified financial planner Ken Waltzer, co-founder and managing partner of KCS Wealth Advisory in

Los Angeles.

If you plan on more income or higher taxes in retirement, tax-free withdrawals from Roth contributions may make sense, and tax-deferred contributions may be better if you expect lower earnings and levies.

Share of 401(k) plans with Roth

The share of plans that allow Roth savings grew by 37 percentage points over a decade.



Source: Plan Sponsor Council of America

But that's not always a winning strategy, according to Michelle Gessner, a Houston-based CFP and founder of Gessner Wealth Strategies.

"Investors are quick to discard the idea of making Roth contributions if they are in a high tax bracket because they want the deduction that comes with a regular 401(k) contribution," she said.

However, the upfront write-off may not be worth it if you worry about the consequences of taxable required minimum distributions, she said.

Social Security and Medicare costs

Social Security and Medicare costs

VIDEO 02:13

Fidelity to offer customers the option to put bitcoin in their portfolios

When someone withdraws tax-deferred money from a 401(k), it boosts their income, which may trigger levies on Social Security and hike Medicare premiums.

The formulas for Social Security taxes, Medicare Part B and Medicare Part D use so-called modified adjusted gross income, or MAGI.

If half of your Social Security payments plus MAGI is more than $34,000 ($44,000 for a joint return), up to 85% of those benefits may be taxable.

However, the bigger issue for retirees above certain income levels may be the surcharge for Medicare Part B, known as the Income Related Monthly Adjustment Amount, or IRMAA.

Medicare 2022 Part B premium adjustments

All figures in USD

Individual tax return	Married file jointly	Adjustment	Payment
91K or less	182K or less	0	170.10
Above 91K up to 114K	Above 182K up to 228K	68	238.10
Above 114K up to 142K	Above 228K up to 284K	170.10	340.20
Above 142K up to 170K	Above 284K up to 340K	272.20	442.30
Above 170K and less than 500K	Above 340K and less than 750K	374.20	544.30
500K or more	750K or more	408.20	578.30

Source: Centers for Medicare & Medicaid Services

While the base amount for Medicare Part B premiums is $170.10 for 2022, payments go up once income exceeds $91,000 ($182,000 for joint filers). The calculation uses MAGI from two years prior.

Roth withdrawals, however, won't show up on tax returns, said Gessner, meaning retirees don't have to worry about these distributions causing Medicare premium increases.

Diversify taxes

Since no one can predict future tax rates, you may also consider creating a mix of pre-tax and after-tax

funds from a diversification standpoint, experts say.

"It is great when clients have both Roth and traditional retirement savings," said Catherine Valega, a CFP and wealth consultant at Green Bee Advisory in Winchester, Massachusetts.

If you have both pre-tax and after-tax funds, it may provide more options to craft an efficient retirement income plan, she said.