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May 2000 - Saving for Retirement: Is A 401(K) or a Roth IRA Better?

Should you be saving part of your income in a Roth IRA? If you have a 401(K) or other retirement plan available that includes employer matching of your savings, should you choose that, or the Roth, or both? If you've ever wondered about this when your employer hands you a big 401(K) packet and asks you to fill in the blanks and make serious choices for your future, then this article is for you!

Step 1: Will Your Employer Be Matching Part of Your Retirement Savings?

After looking at lots of numbers, it is clear that if your employer will be matching 25 cents or more for each dollar you put in a 401(K), 403(B), or similar plans, you should take your employer up on the offer and go for their plan. This is true regardless of your tax bracket today or at retirement.

An example of this is a person earning $3,000 per month in the combined 22% Federal and State income tax bracket, who can put up to 3% of earnings into a 401(K) and have an employer match 25% of employee contributions. This person would be paying $90.00 per month in to the 401(K), and saving $19.80 in taxes as a result. Thus the net cost to the employee would be $70.20 per month. The employer would add another $22.50 each month. When the employee is ready to retire, perhaps after 40 years of work, he or she would have paid $80,068 into the plan, including annual 4% cost of living increases. Adjusted back to today's dollars, this person could expect to withdraw $434,200 from the plan with 10% average annual return on investment and after paying taxes at the same combined 22% Federal and State bracket. Obviously, none of these figures are guaranteed. They are simply intended to allow a fair comparison between savings options.

If the same person put their retirement savings into either a traditional or a Roth IRA, using the same tax, inflation, and investment return assumptions, he or she could expect to be able to withdraw $347,400 from the plan, again adjusted back to today's dollars.

Of course the advantage of employer matching grows as the amount of matching increases. In this same example, if employer matching is 50% of employee contributions, the employee could expect to withdraw $521,100, adjusted to today's dollars. At dollar-for-dollar employer matching, the employee would enjoy $694,800 in total lifetime after-tax withdrawals, again adjusted to today's dollars. That is really exciting!

Step 2: If Employer Matching of Retirement Savings is Not Available, Then What Is Best?

Here is where professional help can make a difference of thousands of dollars over a lifetime. You need to take a really good look at what your tax bracket is now and what it is likely to be at retirement. Do not blindly assume that your tax bracket will automatically be lower at retirement, because in many cases it is higher! There are many reasons this is so, including the loss of deductions and credits for children and mortgage interest in most cases, and the fact that taxable retirement income and tax-exempt interest income can make what you thought would be tax-free social security income also taxable.

Once you have made the tough call as to whether your tax bracket will increase or decrease at retirement, it becomes a fairly simple decision. Roth IRAs are the best retirement savings choice when your tax bracket will be higher in the future, and traditional IRAs are the best choice when your tax bracket is higher now. Either type of IRA is preferable over contributions to 401(K)s or 403(B)s that are not matched by an employer, because you have more flexibility with investment choices and you don't have to be concerned about what happens to your retirement savings every time you change jobs.

Another advantage of the Roth IRA is that once you have had your money in the plan for 5 or more years, you can withdraw the money without tax or penalty for a larger list of reasons than other retirement savings options. If you are just graduating from high school, and planning ahead for the down payment on your first home, the Roth IRA can be a great choice!

Step 3: Should I Add to the Retirement Plan I Have Already or Start a New One?

In most cases, you can have both a 401(K) and an IRA. So if you already have a 401(K) and want to increase your retirement savings beyond the maximum amount your employer will match, you will probably want to start a separate IRA for that. If you decide a Roth IRA is good for you, does that mean you should convert your existing plan to a Roth? This is another question you should take to your professional tax advisor. There is a one-time conversion tax to switch existing funds to a Roth, and you will want to evaluate whether the benefits are worth this tax.

A final question: If I am in a financial bind, is my retirement plan funds a good solution?

Talk to your tax advisor for sure! In most cases, you not only will have to pay regular Federal and State income taxes, but also a 10% Federal penalty, and sometimes a state penalty as well. So make sure it is worth the cost before taking that retirement plan withdrawal early!

Next month:

I hope to have you with me then. If you have a topic you would like to see covered in these monthly articles, please contact the Journal.