Rethinking Retirement Contributions

The TCJA generally lowered federal income tax rates, with some exceptions. Among the ways in which lower rates impact tax planning, they make unmatched contributions to traditional employer retirement plans less attractive.

Example 1: Chet Taylor has around $100,000 in taxable income a year. Chet contributed $12,000 to his company's traditional 401(k) in 2017, reducing his taxable income. He was in the 28% tax bracket last year, so his federal tax savings were $3,360 (28% of $12,000). An identical contribution this year will save Chet only $2,880, because the same income would put him in a lower 24% bracket.

Not everyone will be in this situation.

Example 2: Denise Sawyer has around $200,000 taxable income a year. Denise contributed $12,000 to her company's traditional 401(k) in 2017, reducing her taxable income. She was in the 33% tax bracket last year, so her federal tax savings were $3,960 (33% of $12,000). An identical contribution this year will save her $4,200 because the same income would put her in a higher 35% bracket.

Planning Pointers

Considering the changes in tax rates, participants in employer sponsored retirement plans should review their contribution plans. If your company offers a match, be sure to contribute at least enough to get the full amount. Otherwise, you're giving up a portion of your compensation package.

Beyond that level, decide whether you wish to make unmatched tax-deferred contributions to your traditional 401(k) or similar plans. The value here is tax deferral and the ability to compound potential investment earnings without paying current income tax. Deferring tax at, say, 12%, 22%, or 24% in 2018 will be less desirable than similar deferrals were last year, when tax rates were 15%, 25%, or 28%.

On the Roth Side

If you decide to cut back on tax-deferred salary contributions, spending the increased current income won't help you plan for your future retirement. Other savings tactics may be appealing.

For instance, your employer might offer a designated Roth account in its 401(k) plan. These accounts offer no upfront tax benefit because they're funded with after-tax dollars. The advantage is all withdrawals, including distributions of investment income, will avoid income tax after age 59½, if you have had the Roth account for at least five years. (Other conditions can also qualify distributions from a Roth account for full tax avoidance.)

Generally, the lower your current tax bracket and the higher your expected tax bracket in retirement, the more attractive Roth contributions can be.

Example 3: Ed Roberts, age 30, expects his taxable income (after deductions) to be around $50,000 this year, putting him in the 22% tax bracket. Ed hopes to have a successful career, so he might face a higher tax rate on distributions in the future. Therefore, Ed contributes $6,000 ($500 a month) to his company's traditional 401(k) to get some current tax relief, and $6,000 to the Roth 401(k) for tax free distributions after age 59½.

Some advisers suggest going into retirement with funds in a regular taxable account, funds in a tax-deferred traditional retirement account, and funds in a potentially tax-free Roth account. Then, you may have considerable flexibility in choosing tax-efficient ways to draw down retirement cash flow.

Other Options

What if Ed's employer's 401(k) plan does not offer designated Roth accounts? A possible solution for Ed would be to contribute to a Roth IRA instead. In 2018, he can contribute up to $5,500 ($6,500 for those 50 and older). Roth IRAs also offer completely tax-free distributions after five years and age 59½.

Example 4: Assume that Ed's employer will match up to $4,500 of his 401(k) this year and that Ed plans to save $12,000 for his retirement. Ed could contribute $5,500 to a Roth IRA and $6,500 to his traditional 401(k).

With higher incomes ($120,000 or more of modified adjusted gross income for single filers in 2018, $189,000 for couples filing jointly), Roth IRA contributions are limited or prohibited. People facing this barrier may able to fund a nondeductible traditional IRA, up to $5,500 or $6,500 this year, then convert those dollars to a Roth IRA with little or no tax at this year's tax rates. (IRA contributions for 2017, with slightly different income limits, are possible until April 17, 2018.)

Ultimately, the choice between traditional and Roth retirement accounts will largely depend on expectations of future tax rates. Deferring tax in a traditional plan this year and saving 24% in tax may not turn out to be a good deal if future withdrawals are taxed at 28%, 30%, or 35%. The fact that the

TCJA rates are among the Act’s provisions that are due to sunset in 2026, reverting to 2017 rates, may tilt the scales a bit towards the Roth side, where distributions eventually may escape tax altogether.

Trusted Advice

Retirement Rules

- Participants in 401(k) and similar employer sponsored retirement plans can contribute up to $18,500 this year, or $24,500 if they’ve reached age 50.
- If your company’s 401(k) plan offers a designated Roth account, contributions to the plan can be divided in any manner you choose between a pre-tax account and a designated Roth account, but the total can’t exceed the $18,500 or $24,500 ceilings.
- Any employer match usually goes into the traditional 401(k), even if the contribution is to the Roth version, so income tax on the matching money is deferred.