Should High Income Earners Make Roth 403(b) Contributions?

Fall 2016
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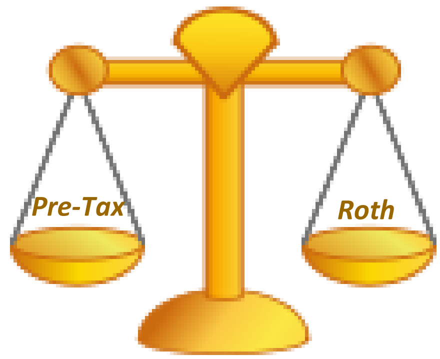
Much has been written about the financial power of the Roth 403b/401k. Yet high income earners are faced with a dilemma. Each dollar chosen for an after-tax Roth contribution that will provide a tax benefit in retirement, robs them of a pre-tax contribution which lowers their taxable income today. Does this trade-off make good financial sense for those in a higher tax bracket?

You've likely heard that having a sizeable Roth balance is the piece-de-resistance of a well-constructed retirement savings plan. What's not to like? Having a tax-free bucket of money at your disposal in retirement will add important financial flexibility. After all, it's how much you keep in your pocket after paying taxes that matters, right?



Yet, in our experience, high-income-earners mostly prefer their retirement plan contributions to be pre-tax rather than after-tax Roth, in order to realize a tax-savings today. In this article we will demonstrate that focusing solely upon today's tax benefit comes at potentially a very steep long-term price to your financial future.

Ideally, one would choose to designate all of their retirement plan contributions to Roth. However, with today's income tax scheme, top wage earners can pay well over 40% in federal income taxes once all of the various taxes are added in. Thus, we will present a realistic and practical contribution strategy which utilizes both pretax and Roth options.

First, let's start with a brief review of each contribution option.

Traditional pretax 401k/403b contributions provide a tax benefit today by reducing one's taxable income which results in a lower current income tax bill. For example, if you pay a 30% effective tax rate and contributed $10,000 of your pay in a pre-tax manner, you would reduce your taxable income by $10,000 and thus save $3,000 in federal income taxes.

Note: while the marginal income tax bracket determines the amount of income tax on each additional dollar of income, the effective tax rate is a number unique to each household which takes into account our progressive income tax brackets as well as deductions and credits.

You won't have to pay taxes on the growth these contributions earn until you withdraw money from your retirement account. Presumably, but not always, your effective tax rate will be lower in retirement than it is today. If this were to be the case, then you successfully traded paying income taxes at a higher tax bracket today for paying taxes at a lower bracket in retirement.

Roth contributions provide a tax benefit in retirement when you are able to withdraw the money without paying income taxes. There is a tradeoff, however: you will end up paying more income tax today in order to receive many years of tax-free income in retirement.

Let’s assume you are retired and you need to withdraw an additional $50,000 from your retirement accounts to cover living expenses. With a Roth 403b/401k/IRA you simply withdraw and spend the $50,000 – there is no income tax liability.

While pre-tax contributions provide a tax benefit today, you will pay income tax when you take the money out in retirement. Let's consider the following example. Assuming you have an average tax bracket (federal and state taxes) of 25%, you would owe $12,500 on the same $50,000 withdrawal leaving you with only $38,500. In order to hit your $50,000 after-tax spending goal, you actually would need to withdraw $66,668. That’s $16,668 that could be left to grow in your retirement account! Thus the power of the Roth – greater financial flexibility in retirement.

A tale of two savers. Let’s consider a hypothetical example of two physicians, Peter Pretax and Robert Roth, just getting started in their medical careers at the age of 35. Both are excited about finally earning compensation of $300,000 and are eager to begin saving for retirement.

Savings Assumptions:

- They each will max out their annual contributions ($18,000 in 2016, $24,000 max for those 50 and older) for the next 30 years until they retire at 65.
- Compensation will grow by 2% per year.
- Their portfolios will earn a 7% pre-retirement return and a 5% annual return in retirement.
- Their employer provides a pre-tax matching contribution equal to 4% of their compensation as long as they are contributing 5% or more.
- They each will save $6,475 annually in a non-retirement account.

Tax Goals:

Peter Pre-tax wants to reduce his current income tax bill as much as possible thus all of his contributions are on a pre-tax basis. Robert Roth is keeping an eye focused on retirement and the other on reducing income taxes today. He decides to split his contributions between pre-tax and Roth.

Retirement Assumptions: *(See next page for a comparison of each scenario.)*

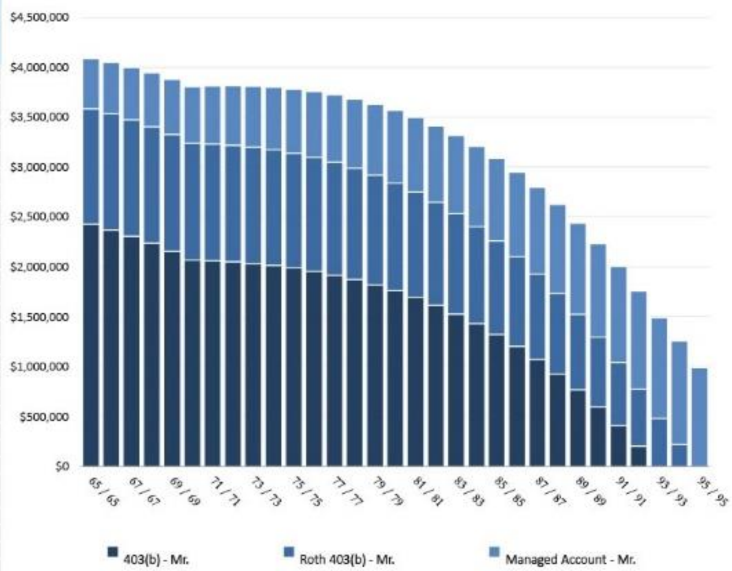
- Retirement age: 65
- Year 1 retirement income equal to 39% of final year employment compensation.
- Both end up with total retirement account savings of $3,584,910:
    - Peter Pretax’s entire balance is in his pre-tax 403b.
    - Robert Roth has a pre-tax 403b balance of $2,428,326 and a Roth 403b balance of $1,156,581. *Note: the pre-tax balance is greater due to the employer match.*
- Each household starts retirement with $500,000 in a non-retirement investment account.
- To supplement social security, each will need to withdraw $187,163 in the first year of retirement to meet living expenses - which will grow at 2.5% per year.
- Withdrawals will take place in the following order with the goal of keeping the average effective income tax rate at 25%:

1. Withdraw from the pre-tax 403b
2. Withdraw from the non-retirement account
3. Withdraw from the Roth 403b

Net Worth Detail

The table below represents the projected Net Worth using end of year values. The chart further details the portion signified by each account.

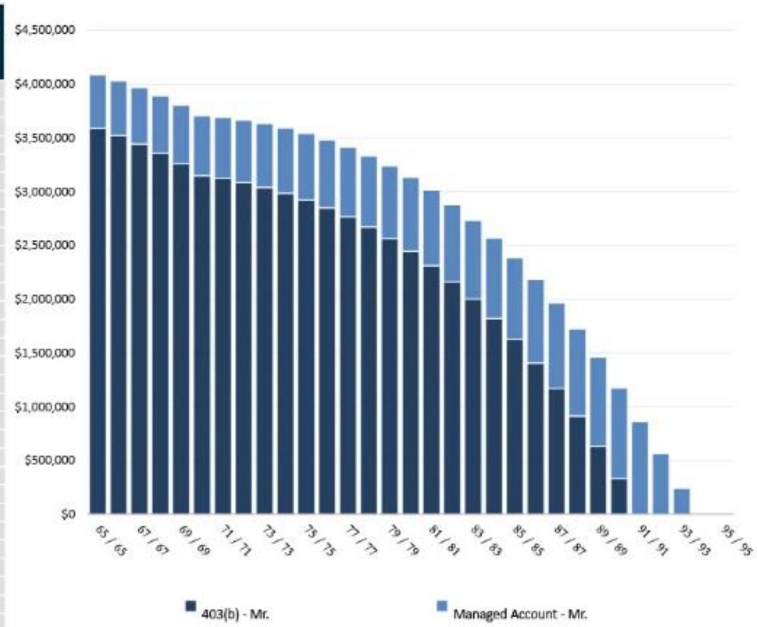
Age at Year End	Investible Net Worth
65 / 65	$4,084,907
66 / 66	$4,046,271
67 / 67	$3,999,631
68 / 68	$3,944,435
69 / 69	$3,880,100
70 / 70	$3,806,009
71 / 71	$3,813,260
72 / 72	$3,814,922
73 / 73	$3,810,551
74 / 74	$3,799,680
75 / 75	$3,781,813
76 / 76	$3,756,424
77 / 77	$3,722,957
78 / 78	$3,680,823
79 / 79	$3,629,400
80 / 80	$3,568,030
81 / 81	$3,496,014
82 / 82	$3,412,617
83 / 83	$3,317,060
84 / 84	$3,208,520
85 / 85	$3,086,126
86 / 86	$2,948,961
87 / 87	$2,796,052
88 / 88	$2,626,376
89 / 89	$2,438,848
90 / 90	$2,232,327
91 / 91	$2,005,606
92 / 92	$1,757,411
93 / 93	$1,490,768
94 / 94	$1,255,761
95 / 95	$989,043



Net Worth Detail

The table below represents the projected Net Worth using end of year values. The chart further details the portion signified by each account.

Age at Year End	Investible Net Worth
65 / 65	$4,084,910
66 / 66	$4,028,980
67 / 67	$3,963,749
68 / 68	$3,888,589
69 / 69	$3,802,838
70 / 70	$3,705,795
71 / 71	$3,688,469
72 / 72	$3,663,834
73 / 73	$3,631,352
74 / 74	$3,590,450
75 / 75	$3,540,523
76 / 76	$3,480,932
77 / 77	$3,410,999
78 / 78	$3,330,008
79 / 79	$3,237,205
80 / 80	$3,131,788
81 / 81	$3,012,914
82 / 82	$2,879,689
83 / 83	$2,731,170
84 / 84	$2,566,362
85 / 85	$2,384,214
86 / 86	$2,183,614
87 / 87	$1,963,391
88 / 88	$1,722,308
89 / 89	$1,459,060
90 / 90	$1,172,270
91 / 91	$860,149
92 / 92	$563,574
93 / 93	$242,183
94 / 94	$0
95 / 95	$0



Retirement Income Comparison

Peter Pretax and his spouse will run out of money at age 93. Not a terrible result - unless he or his spouse is still alive at that point! It is prudent to plan for some margin in case either spouse should live longer, someone experiences a long term care event, inflation is greater than expected, investment returns are less than expected or tax rates are greater than expected.

Robert Roth and his spouse will still have a net worth of $1,255,761 at 93; a sufficient amount of assets to cover most unexpected twists and turns brought on by life in retirement. Of this amount, his Roth 403b balance will be $220,382 while the rest of the money will reside in the non-retirement investment account.

Total Income Taxes Paid through age 93

- Peter Pre-tax: $1,810,576 on retirement withdrawals.
- Robert Roth: $1,197,497 on retirement withdrawals and $94,830 in additional income tax while working equals a grand total of $1,292,327 in taxes.

Conclusion. In our study, the pre-tax/Roth savings strategy resulted in an ending net worth approximately $1.2mm greater than the 100% pre-tax strategy which ran out of income and assets before the final year. The combo strategy paid a lot less in cumulative taxes – approximately $500,000.

Therefore, by utilizing both pre-tax and Roth 403b contributions, the high income household has the potential to receive the following benefits (vs. using only pre-tax contributions):

- *Have greater financial flexibility in retirement*
- *A longer lasting retirement income*
- *The option of taking a higher amount of income*
- *Pay less in cumulative income taxes*
- *Pass on a greater amount of wealth to their heirs*

This is true even though they will be giving up a greater current income tax benefit that comes with the pre-tax contributions.

Consider how you may use Roth 403b contributions to improve your financial future.

Caveats, calculations and other in-the-weed details:

Caveats: *A basic savings and income projection was used to simplify this planning scenario for the sake of the article. Of course investments won't provide a return, year-in-and-year-out, equal to the average rate of return. In fact, geometric returns are more appropriate to use than arithmetic returns. The sequence of when the negative returns occur during retirement may have a substantially negative impact the life of a retirement plan. Withdrawals will need to be nuanced to optimize the tax plan as well. We use a much more sophisticated planning process in advising our clients on the effectiveness of their retirement income plan. The basic premise – that diversifying one's retirement savings between pre-tax, Roth and taxable non-retirement accounts may add a high degree of financial flexibility in retirement – is nevertheless correctly represented in this study given the great disparity in the results between the scenarios.*

Income tax calculations. *For the pre-tax scenario, determining the total income taxes paid is relatively straight forward: we apply the 25% average tax to withdrawals from the pre-tax account and tax withdrawals from the taxable account using the 15% capital gains rate.*

For the scenario including the Roth account, these tax assumptions also apply however we need to account for the additional income tax Peter paid as a result of directing some of his deferrals away from pre-tax into after-tax Roth contributions each year. To do this we multiplied each year's Roth contribution by the effective income tax rate of 29%.

For 15 years of deferrals x $9,000 x .29 = $39,150 plus 16 years of deferrals at the catch-up level x $12,000 x .29 = $55,680.

About the Author Eric Coffman MBA, CFP®, AIF®

Eric is a founding partner of the independent wealth management practice, Wealth Impact Advisors, LLC. He has provided financial guidance to medical professionals, business owners and families for over two decades. He is proud to serve clients in a fiduciary capacity as a CERTIFIED FINANCIAL PLANNER™ practitioner and an Accredited Investment Fiduciary®.

Eric's passionate about helping people explore how they can use their wealth to live the best life possible which includes having a positive impact on loved ones and their community.

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