Roth or traditional IRA or 401(k)—two tips for choosing

Posted: 4/15/2015 by Fidelity Viewpoints

Taxes and how you manage your money can help you in figuring out a better way to save.

Roth or traditional—Ask yourself this:

- Do you want a tax deduction on contributions made today?
- Do you think you'd prefer tax-free distributions in retirement?
- Do you think your taxes in retirement will be higher or lower than now?
- Do you spend all you make?

Is your first instinct to spend a bonus, tax refund, or other windfall on expensive shoes or the latest smartphone or do you put it right into a savings account? The answer to that question may help you make another important decision: where to save for your future—aka retirement.

If you work for a large employer, you can usually choose to save in either a traditional or Roth 401(k), or in some cases a traditional or Roth 403(b). If you are self-employed or if a 401(k) isn't offered where you work, the choice will usually be traditional or Roth IRA. So, how should you choose?

"There are two things to keep in mind when choosing between a traditional or Roth 401(k) or IRA," say Matt Kenigsberg, vice president of financial solutions at Fidelity. "Taxes and how you manage your money."

Let's dive into each. [Note: We will refer to 401(k)s throughout the story for simplicity, but the same principles also generally apply to 403(b) or governmental 457 plans, as well as to most IRAs.]

Taxes: now or later?

One key difference between a traditional and Roth 401(k) is taxes.

With a **traditional** 401(k), your contributions are pretax: they generally reduce your taxable income, lowering your tax bill in the year you make them. But your money doesn't avoid taxes entirely; you'll pay income taxes on any money you withdraw from your traditional 401(k) in retirement.

A **Roth** 401(k) is exactly the opposite. Contributions are made after tax, with money that has already been taxed, but you generally don't have to pay taxes when you withdraw from your account.

Essentially, you need to choose between taking a tax deduction on contributions made today or withdrawing contributions and earnings tax free in retirement. The key is to get the tax deduction when you think your taxes are going to be the highest. In general:

- If you think your tax rate will be significantly higher when you retire than it is now, a Roth 401(k) may make sense, because withdrawals are tax free.
- If you think your tax rate will be significantly lower in retirement than it is now, a traditional 401(k) may be more appropriate, because you will pay a lower tax on your withdrawals.

Spenders vs. savers

But while some people may have good reason to believe that their tax rates will be a lot higher or lower in retirement, for others it is pretty much a guess. That's where the way you manage money comes in. Are you a spender or a saver? Do you live paycheck to paycheck or make saving some of it a priority? Your answers can help you choose which type of account.

Traditional 401(k)s leave money in your pocket. Generally, contributions to a traditional 401(k) lower your current taxable income. This gives you more money in your pocket, but these tax savings can only help you reach your retirement goals if they're invested. If you get a tax refund and go out and spend it, it's not going to help your bottom line when you retire.

Roth 401(k)s reduce the money in your pocket. With Roth contributions, you pay taxes on your contributions up front. That takes away from your current income or take-home pay, because more tax will be taken out. But, if you're like many people, who tend to spend what they earn anyway, having less money to spend might be a good thing when it comes to your retirement savings. You've already paid your taxes, so you get to take your money out tax free,[1] which could leave you more to spend in retirement. "In a sense," says Kenigsberg, "a Roth 401(k) can force you to save more for later by keeping less in your pocket now."

An example

Meet three hypothetical investors—Brian, Sara, and Sam. Each is 45, married, and would like to retire at age 65. But, when it comes to money, they are very different.

Brian is frugal and a relentless saver and investor. He tracks every penny, and if he has some money left over at the end of the month, he invests all of it. Same goes for any windfalls. He automatically contributes to a traditional 401(k) every paycheck, and he always puts his tax refund into a taxable brokerage account, to keep his money working for him.

Sara spends her paycheck. When she gets a tax refund or has money left over from her paycheck, she doesn't save any of it. Instead, she goes out to dinner or goes shopping and takes vacations. She also automatically contributes to a traditional 401(k).

Sam has a lot in common with Sara. He'll spend his money if it is available on his debit card, but he contributes to a Roth 401(k) at work. He likes the idea of not having to pay taxes on the money when he begins to use it in retirement.

Let's run some numbers.

Each contributes $5,000 to a 401(k) at age 45 and plans to keep it in the account until age 75, or about 10 years after they retire. That's a 30-year time horizon. Brian and Sara both receive a $1,400 tax refund, because they made traditional 401(k) contributions. Sam doesn't receive a refund, because his Roth 401(k) contribution doesn't reduce his taxable income.

How much would they each have after 30 years, after paying taxes, based on the type of 401(k) account they chose, and whether they saved or spent their tax refund? Take a look:

Which type of 401(k) may be right for you?

Our three savers are 45, plan to use their savings at age 75, but have different personalities. Here's what their $5,000 contributions may be worth, after tax, in 30 years.

	Saver or spender?	Type of 401(k)	Tax refund	Contribution value after 30 years
Brian	Relentless saver	Traditional, pretax	$1,400 Invests the refund	$35,445*
Sara	Shopaholic	Traditional, pretax	$1,400 Spends on vacations	$27,404*
Sam	Spends debit card money	Roth, after tax	No refund	$38,061*

*After paying taxes at the time of withdrawal.

Marginal income tax rate: 28% (assumed current rate)
Expected marginal income tax rate in retirement: 28%

Hypothetical pretax return on investments: 7%
Hypothetical after-tax return on investments: 6%

As you can see, Sara has the lowest balance after 30 years, since she chose the pretax 401(k) and spent her entire tax refund. Her account grows to $38,610 just like Sam's Roth 401(k), but she then has to pay more than $10,657 (or 28%) in taxes when she withdraws the money in retirement, so she ends up with $27,704, or $10,657 less than Sam.

Brian ends up with more than Sara. After paying taxes in retirement, he ends up with the same $27,404 from his 401(k) that Sara does, but he comes out ahead because of his additional taxable investments—remember that Brian invests his $1,400 tax refund in a brokerage account. In this example, we assume that will have grown at 6% annually. Why the lower rate? Because as Brian invests, he may have to pay taxes on his brokerage account earnings, and we are assuming those taxes will reduce his return from 7% pretax to 6% after tax (this is just an example—the reduction in return due to tax could be more or less than 1%). At 6%, Brian will have $8,041 in his taxable account after 30 years, so he'll have a total of $35,445.

Sam ends up with the most. His Roth 401(k) grows to $38,061, but he doesn't have to pay any tax when he withdraws the money. The Roth 401(k) gives Sam two advantages that account for the difference: First, the Roth captured all of Sam's tax savings—safe from his temptation to spend it before retirement; and second, all his savings were able to grow tax free in the retirement account. Hence, he achieves a higher rate of return than Brian in this hypothetical example.

This shows that a Roth 401(k) might actually be an easier way to reach your savings goals, because for those who are tempted to spend—like Sara—it removes temptation; and even for those who are not—like Brian—it can lead to higher after-tax returns. "Given that most people tend to spend what they earn more quickly," says Kenigsberg, "perhaps having less in your pocket now leads to more later."

But remember, that's not the whole story. Our example doesn't take into account possible changes in Sara, Ben, and Sam's future tax rates. To the extent that any one of them winds up with tax rates in retirement that are much lower than they are now, at age 45, that would tend to tilt the scales in favor of a traditional 401(k). Conversely, if they end up with tax rates that are a lot higher than today, that would tend to favor a Roth 401(k). So the message is this: it's important to know the numbers and think about your current and future tax rates when making a retirement plan, but it's important to know yourself and the way you handle money, too.

1. A distribution from a Roth IRA is tax free and penalty free provided that the five-year aging requirement has been satisfied and one of the following conditions is met: age 59½, death, disability, qualified first-time home purchase.

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