Roth, Traditional or Both: Considerations to Weigh

There are a number of Roth and traditional retirement plan options that may be available for you when planning for retirement. We review key considerations when choosing a plan type so you can make the most appropriate decision for you and your family. This is not necessarily an either/or decision; you may be able to use more than one option.

Will my taxes be higher now or later? That is often the top consideration for people when choosing whether to make contributions to a Roth or traditional retirement plan. Roth account contributions are made with after-tax money; qualified withdrawals are tax free. Traditional accounts, both IRAs and defined contribution, 401(k) and 403(b), provide a tax break when you make your contribution; withdrawals are taxed. Your income tax bracket will be a reflection of any Social Security benefits, defined benefit payments, wages, taxable investments, and traditional plan withdrawals.

There are, however, a number of other factors beyond future tax rates to consider. The decision is not necessarily limited to one type of account or the other. Holding money in both Roth and traditional accounts can help provide diversification and some flexibility to manage certain changes that may arise.

It’s Not Just Future Tax Rates

On the face of it, the decision to use a traditional or Roth plan appears straightforward. If you expect your tax rate will be lower when you make the withdrawal in retirement, a traditional plan may offer you more spendable income. If you expect your tax rate will be higher or the same when you make the withdrawal in retirement, a Roth may provide you with more spendable income.

The challenge is there is no way to know what future tax rates will be. Any particular administration could change rates up or down. Congress could specifically change the rules related to Roth accounts and affect the tax-free nature of withdrawals, and any change affecting the income tax code could have an effect on withdrawals from traditional accounts. Even if you had a crystal ball and could predict future tax

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1 Roth contributions may be withdrawn at any time without taxes or penalties (subject to plan rules if a Roth 401(k)). Earnings may be withdrawn tax-free and penalty-free once the account has been open for at least five years and you reach age 59 1/2, become totally disabled, or die.

2 For IRAs, based on modified adjusted gross income (MAGI) and eligibility to participate in an employer-sponsored retirement plan (or your spouse’s participation).
rates, there are other considerations to be weighed. Below we explore five of those.

**Your Expected Income in Retirement**

“Understanding your current spending requirements before you retire will help you have a smooth and successful transition to begin writing your next chapter,” says Mary Ellen Hancock, senior wealth strategist, PNC Wealth Management. “This takes careful planning today to determine what income and expenses will be eliminated when you retire as well as what new expenses will be added.” Also, she notes it is important to understand what income sources will be available to cover expenses during retirement.

Many people believe their spending will decrease in retirement. Some think they will draw less income from their retirement accounts than they made preretirement and will therefore be taxed at a lower rate. The Bureau of Labor Statistics Consumer Expenditure Survey confirms this, finding on average that people age 65–74 spend about 85% of those age 55–64, and people age 75 years and older spend 65%. A lower tax bracket may help support a traditional plan.

At the same time, people can sometimes overestimate how much their spending needs might decrease and whether the decrease will move them into a lower tax bracket. If spending does not decrease and tax brackets stay the same or move higher, a Roth may be the better option to consider.

Using both Roth and traditional plans may help address some of the uncertainty over what the tax bracket may be when you retire and your spending needs change.

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### Budgeting for Retirement

We recommend working with your advisors to get the most realistic postretirement budget. Some considerations include:

- Will you have a mortgage?
- Do you plan to live in a high property tax state?
- Do you have other debt?
- Do you plan to buy a second home or travel?
- If you are a distance from children and grandchildren, what types of travel expenses might you have to cover visits?
- Is there a chance you might be looking after your grandchildren while your children are working? You may be picking up the so-called “pocket change” items.
- If we were to fast-forward to when you are in your 80s and 90s, what type of long-term care coverage do you have in place? Are you planning to self-insure? Depend on social services?

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Unexpected Spikes in Expenses

Just as during preretirement, expenses do not occur in a steady, predictable fashion each month, with costs rising exactly with inflation. Often, they appear as a spike—an irregular, large expense that is in addition to your regular lifestyle expenses. Spikes could be due to positive events, such as buying a recreational vehicle or helping a grandchild with college expenses. Or these spikes could result from difficult events, such as a major medical expense.

When a spike in expenses occurs, withdrawing from a traditional account to pay for it can result in some unpleasant consequences, such as:

- higher Medicare premiums;
- more of your Social Security benefits being taxed; and
- raising your tax bracket.

Qualified withdrawals from Roth accounts are tax free and do not affect your taxable income and treatment of your Medicare and Social Security benefits.

Required Minimum Distributions (RMDs)

If you do not think you will need to start making withdrawals by age 70 1/2, Roth options may have some advantages over traditional plans. This is because traditional accounts, both 401(k)s and IRAs, require you to withdraw money once you reach age 70 1/2, while Roth IRAs do not (with some exceptions). Roth 401(k)s are subject to RMDs, but that money can be rolled tax free into a Roth IRA, which does not have RMDs.

Taxes generally must be paid on traditional account withdrawals, including RMDs.

Gifting to Heirs: Roth or Traditional?

For those who plan to leave all or a portion of their retirement plan assets to heirs, the question is whether to contribute those assets to a Roth or traditional plan. There is no one answer. Sometimes it is simply a matter of personal preference.

If you expect your heirs to be in a lower tax bracket when they withdraw the money than you are currently in

Roth: Traditional or Both?

There are a number of factors that go into deciding whether to contribute to a Roth or traditional retirement plan if both are available options. For many individuals, both may be the best plan. Below we list five considerations we believe are worth exploring when deciding:

- whether your expected future tax rate will be higher or lower in retirement;
- your projected spending requirements, or necessary income;
- the impact of unplanned expenses during and prior to retirement;
- if you plan to gift some or all of your retirement plans to heirs; and
- what percentage of each of your retirement plans will you need to make withdrawals from at age 70 1/2 to sustain your lifestyle.
now and you are most interested in maximizing your gift, a traditional account would seem the best choice. But predicting future tax rates—and even future financial resources of your heirs—is virtually impossible. If you would like to remove the uncertainty, a Roth would appear the better choice even if it might result in a lesser gift because the initial contribution was reduced by taxes. Additionally, some prefer a Roth for a bequest since it is more straightforward in the eyes of the inheritors. Psychologically receiving an untaxed gift may feel more gratifying than receiving a larger gift that one has to lessen by paying taxes on it.

**Taxes and Penalties**

The unexpected happens more often than most people would like, leaving many with no option other than to withdraw funds from retirement accounts before reaching retirement age. One benefit of a Roth account is there are no taxes or penalties applied to early withdrawals on your original Roth contributions—only earnings withdrawn from a Roth incur taxes and a 10% penalty (with some exceptions). This is not the case for traditional accounts. Taxes generally apply to money withdrawn from traditional accounts and, if withdrawn before age 59 1/2, a 10% penalty (with some exceptions).

Many traditional 401(k) and 403(b) accounts, however, may contain loan provisions, which may allow you to borrow money from your current employer’s account tax free and pay yourself back with interest. As long as you can meet the payment schedule, this option may be preferable to a taxable withdrawal.

There are a number of factors to weigh when choosing the best retirement plan options for you and your family. Roth and traditional accounts have different features that will affect planning for your postretirement assets. Speak with your advisors to determine the option, or combination of options, that may be available and appropriate for you.

For more information, please contact your PNC advisor.