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JOURNAL REPORTS

Does Switching to a Roth 401(k) Make Sense?

April 25, 2014 3:45 p.m. ET

It's a question of paying taxes now or later, and there are pros and cons of both Roth 401(k) accounts and their traditional counterparts. So we asked The Experts: **What are the pros and cons of switching to a Roth 401(k)?**

This discussion relates to the latest **Wealth Management** *Report and formed the basis of a discussion on The Experts blog in April 2014.*

High earners can't contribute directly to popular Roth individual retirement accounts. But there's still a way in. We explain a simple two-step strategy that works for many people. WSJ's Karen Damato explains.

How to Decide Whether to Switch to a Roth 401(k)

MICHAEL KITCES : As more employers make Roth 401(k)s available in addition to the pretax "traditional" version—and anyone up to certain income limits can choose between traditional and Roth IRAs—the question arises: Is it better to pay the taxes now and get tax-free growth in the future (with a Roth), or take

the tax deduction now even if it means paying taxes later with a traditional 401(k).

The answer is actually quite straightforward: Choose to pay your taxes whenever your tax *rate* will be lower. If you believe your tax rate will be lower in the future, it's better to claim the tax deduction now (with a traditional) and deal with the taxes later. If you believe your tax rate will be higher down the road than it is now, go ahead and contribute to the Roth.

In essence, this means your future tax rate becomes a form of "[tax] limbo bar" that you have to be able to get under to win at the Roth game. As long as you can keep your current income below the bar, go ahead and limbo under with a Roth. If it looks like you're going to hit the bar, a traditional is better.

How do you know what your tax rate will be in the future? It isn't always easy to tell, but we can often judge based where we are now. If you're early in your career and upbeat about your potential to grow your wealth, your 10% or 15% tax bracket now is almost certainly more appealing than your future. If you're in your peak earnings years and your tax bracket is 33%+, the odds are more likely than your tax rates will be lower in retirement once those wages are no longer part of the picture. In the middle—the 25% and 28% tax brackets—you'll have to consider whether you'll be able to accumulate enough in investments, retirement accounts, pensions, Social Security, and other retirement income such that at the margin, your tax rate really will be higher in the future. Again, if you don't think you will be that high once your wages are gone, choose the traditional 401(k); if you think it will all add up to more, go with the Roth.

Of course, there are a few other factors that impact the Roth vs traditional 401(k) (or IRA) decision beyond just current versus future tax rates, but choosing to pay your taxes when the *rate* is the lowest is still the dominating factor in the decision. The only caveat is that you should always be certain that you contribute enough to fully maximize any employer match you're eligible for in the first place, as it's always important to take advantage of the "free" money of a good match, even if you give up on a chance to Roth your way under the tax limbo bar!

Michael Kitces is a partner and director of research for Pinnacle Advisory Group, and publisher of the financial planning industry blog Nerd's Eye View. You can follow him on Twitter at @MichaelKitces, or connect with him on Google+.

The Pros and Cons of a Roth 401(k) Conversion

TED JENKIN : Since the Pension Protection Act, Roth 401(k)s are becoming more popular among investors through their employer-sponsored retirement plan. If you have been investing in a 401(k) for some period, it's likely you've chosen the pretax option, and maybe it is time to consider whether a Roth 401(k) conversion makes sense for you.

The Pros:

—If you believe you'll be in a higher tax bracket in the future when you distribute these funds, then converting your existing 401(k) to a Roth 401(k) could make sense.

—Roth 401(k)s are subject to required minimum distributions, but you can easily roll your Roth 401(k) into a Roth IRA and this can allow you to continue to defer dollars within your retirement accounts if you don't need to distribute the money.

—If the market has another depressed year like it has twice in the past 15 years, that particular year could be a really good time to convert your existing 401(k) to a Roth 401(k), especially if you still have a long time

horizon until retirement.

The Cons:

—Make sure you work with your accountant or CPA to really look at the tax implications. Whatever you convert will be taxable income, so consider carefully what tax bracket the conversion may push you into in that tax year.

—You will want to pay for the taxes with cash outside of your 401(k) plan. This could chew up a good portion of your existing cash reserve or liquid brokerage accounts.

—Age works against you. Typically, older participants in their 50s or 60s will have a more challenging time making this conversion. The Roth conversion is more favorable for younger 401(k) participants due to the time frame they have before they will need to access the money.

This isn't intended as an end-all, be-all list, but a Roth 401(k) also could work if you have a year where your income is way down due to a job change or lighter results in your business. In the next several years, it may be time for you to turn the 401(k) light switch to the on position!

Ted Jenkin (@tedjenkin) is the co-CEO and founder of oXYGen Financial, a financial advisory firm focused on the X & Y generations. He also blogs at yoursmartmoneymoves.com.

Don't Forget the Risks of a Roth 401(K)

CHARLES ROTBLUT : The appeal of a Roth 401(K), and a Roth IRA, is the payment of taxes on contributions now versus the payment of taxes on appreciated capital in the future. If a person believes his or her tax rate will be higher in the future than it is now, a Roth account has appeal. Plus, a Roth 401(K) can be rolled over into a Roth IRA without incurring any tax liabilities as long as the conversion rules are followed (e.g. it must be completed within a 60-day window).

There are risks to consider, however. Roth-account contributions are funded with post-tax dollars. Whereas every dollar contributed to a traditional 401(k) is only a 72-cent out-of-pocket expense (for someone in the 28% tax bracket), the same dollar contributed to a Roth IRA costs a full dollar out of pocket. This difference can influence how much money in absolute dollars a person can save. There also are no certainties that a person's tax rate will be higher in the future. Finally, Roth 401(k) plans aren't exempt from the required minimum distribution (RMD); distributions must be taken when a person turns 70 1/2. (Roth IRAs, however, aren't subject to the RMD rules.)

Charles Rotblut (@charlesrotblut) is a vice president with the American Association of Individual Investors.

Your Marginal Tax Rate Is Key to Picking a Retirement Account

MIKE PIPER : The question of whether it's best to contribute to a Roth 401(k) or a regular (tax-deferred) 401(k) is primarily a function of your marginal tax rate. (Your marginal tax rate is simply the tax rate that you would have to pay on an additional dollar of income. For example, if you're in the 25% federal tax bracket and you have a flat 5% state income tax, your marginal tax rate would be 30%, assuming there are no complicating factors at work.)

The general rule of thumb is that:

—If your current marginal tax rate is **greater** than the marginal tax rate you expect to have during retirement, you should prioritize tax-deferred contributions over Roth contributions (because you would rather get the tax break now, while your tax rate is higher).

—If your current marginal tax rate is **lower** than the marginal tax rate you expect to have during retirement, you should prioritize Roth contributions over tax-deferred contributions.

That's the theory anyway.

In real life, making this determination isn't especially easy because your marginal tax rate can be affected by factors other than just your tax bracket. For example, at various points in your life you might be in the 15% tax bracket, but have a marginal tax rate higher than 15% because each additional dollar of income not only causes 15 cents of income tax, it also shrinks the size of a particular tax break for which you're eligible (e.g., the new premium tax credit).

In addition, both the tax law and your personal financial circumstances can change—often in unpredictable ways, making it quite difficult to predict your marginal tax rate 20, 30, or even 40 years in the future.

Because of these complicating factors and uncertainty about the future, "tax diversification"—or contributing to both Roth and tax-deferred accounts—makes sense for many investors.

Mike Piper (@michaelrpiper) is the author of the blog ObliviousInvestor.com. He is also the author of several personal-finance books, including his latest, "Social Security Made Simple."

Roth 401(k) vs. Traditional 401(k): Here's the Math

TERRANCE ODEAN : Mr. A and Mr. B are a lot alike. They pay the same marginal tax rate: 28%. They save the same amount before taxes each year: $5,000. They earn the same investment return each year: 7%. Mr. A puts his savings in a Roth 401(k); thus, each year he contributes $3,600 ($5,000 minus $1,400 taxes). Mr. B puts his savings in a traditional 401(k); thus, each year he contributes $5,000.

After 15 years, both men are over 59 1/2 years old. For simplicity let's assume they both decide to withdraw their entire 401(k) savings. Mr. A has $90,464 in his Roth IRA. He can withdraw the entire amount tax free. Mr. B. has $125,645 in his account. He pays 28% tax when he withdraws this money which leaves him with $90,464. The same as Mr. A. For these two men, the choice of saving in traditional 401(k) or a Roth 401(k) didn't matter.

When might the choice of traditional 401(k) or Roth 401(k) matter?

Both the 401(k) and the Roth 401(k) have the same annual contribution limits. But Roth 401(k) contributions are after-tax. So you can effectively save more in a Roth 401(k). Of course, that means you'll have more money in retirement but less to spend now.

Since contributions to Roth 401(k) are taxed on the way in and contributions to traditional 401(k)s on the way out, Roth 401(k)s may be better if your tax rate is lower now than what it will be when you withdraw your savings. Traditional 401(k)s may be better if your tax rate is higher now than it will be when you make withdrawals.

If you decide to make early withdrawals from your retirement account, you'll get hit with a 10% penalty on any withdrawals from a traditional 401(k). You'll only be penalized on early withdrawals of earnings (but not

contributions) from a Roth 401(k).

Terrance Odean is the Rudd Family Foundation professor and chair of the finance group at the Haas School of Business at the University of California, Berkeley.

The Advantages of a Roth 401(k)

GREG MCBRIDE : There are pros and cons—but far more pros—to devoting some or all of your paycheck contributions to a Roth 401(k).

Unlike traditional 401(k) contributions that are made on a before-tax basis only to be taxed upon withdrawal in retirement, the Roth 401(k) flips this around. Your contributions are made with after-tax money, but upon withdrawal in retirement none of your money—not the contributions or earnings—is subject to taxes.

There are several clear advantages to accumulating 401(k) funds on a Roth basis: diversification from a tax perspective, the ability to withdraw funds in retirement without a tax impact and funds that can be easily rolled into a Roth IRA that isn't subject to required minimum distributions at age 70 1/2.

So what is the catch? Because you are contributing on a post-tax rather than pretax basis, every $100 contribution costs you $100 in net pay, unlike pretax contributions, where a $100 contribution may only cost you $75 to $85 in net pay. Shifting your entire contribution from pretax to post-tax will result in a reduction in your take-home pay. But given the long-term advantages, it is often a price worth paying.

Greg McBride (@BankrateGreg) is senior vice president and chief financial analyst for Bankrate.com, providing analysis and advice on personal finance.

What to Consider Before Switching to a Roth 401(k)

MICHELLE PERRY HIGGINS : Pros of switching to a Roth 401(k):

—Provided you are over 59 1/2 (with some exceptions) and have held the Roth 401(k) for five years, distributions of contributions and any income or gains that have accrued in the Roth 401(k) are entirely tax-free as opposed to traditional 401(k) distributions that are generally taxable as ordinary income.

—You can avoid required minimum distributions (RMDs) on the Roth 401(k) by a rollover to a Roth IRA. Otherwise, like a traditional 401(k) or IRA, your RMD obligation will generally begin at 70 1/2.

—If your employer offers a Roth 401(k) and a traditional 401(k), you can make contributions to both plans as long as the amount doesn't exceed the Internal Revenue Service contribution limit of $17,500 in 2014 ($23,000 for people 50 or older).

Cons of switching to a Roth 401(k):

—Contributions to a Roth 401(k) are made with after-tax money; there is no deduction from your gross income as there is with a contribution to a traditional 401(k).

Michelle Perry Higgins (@RetirementMPH) is a financial planner and principal at California Financial Advisors.

Timing Is Everything With a 401(k)

GEORGE PAPADOPOULOS : What are the pros and cons of switching to a Roth 401(k)? Each situation is different and should be judged based on the specific circumstances of the individual. This issue mainly revolves around the timing of the tax break. In regular 401ks, you get the tax break when you contribute the money into the plan and have to pay taxes when you withdraw the money at retirement. With Roth 401(k) plans, it is the exact opposite. If a person is in the upper tax brackets, it is awfully hard giving up the tax savings now. It becomes easier the younger you are. If I was a college graduate about to start my first job I would likely choose the Roth 401(k) option, as the current tax burden isn't high, the compounding can start as early as possible, and I would be assured a tax-free source of income in retirement.

Another consideration is how much you trust the government and whether it will change the rules in the future. I feel more assured claiming the tax break now instead of in a few (or more) decades because, you know, stuff happens.

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