Millennials: A 401(k), Roth Combo May Win

By Shelly Gigante

Millennials and those with modest incomes listen up: You may be able to give your retirement savings a boost by contributing less to your 401(k). Huh?

Financial professionals say those who qualify for a Roth IRA are sometimes better served by contributing just enough to their 401(k) to secure any employer match that may be available, so as not to leave free money on the table, and then diverting any additional retirement savings to fully fund a Roth. There are caveats, but that's the basic idea.

"For young people, in particular, it is huge to fund a Roth IRA to the max, but only after they get their employer match," said Nancy Coutu, co-founder of Money Managers Financial Group in Chicago, Illinois, in an interview.

It's all about taxes, she indicated.

Retirement Funds and Taxes

A traditional 401(k) is funded with pre-tax dollars, which lowers your taxable income in the year you contribute, and the money in your account can grow tax-deferred until retirement, when withdrawals are taxed as ordinary income.

The reverse is true for Roth IRAs, which are funded with after-tax dollars, so there is no immediate deduction for your contribution, but you pay no taxes on earnings and qualifying distributions when you withdraw.

The thought is that, over the long haul, any tax-free growth on Roth IRA (after tax) contributions might have the potential to outperform tax-deferred growth on pre-tax 401K contributions. Coutu indicates this might be the case, especially for millennials who have decades of earnings potential ahead. Because their income will likely rise throughout their career, their tax bill today is also likely to be lower than it will be in retirement.

But that is not the only tax benefit to a Roth IRA.
Retirees do not need to distribute (withdraw) money from their Roth IRA account during their lifetime, which allows those funds to retain their tax-free status throughout retirement, a major perk. And, if they never need the money in their account it can be passed along to their spouse or heirs when they die. Non-spouse heirs who transfer the assets to an inherited IRA held in their own name, may be able to stretch their required minimum withdrawals out over their own life expectancies, allowing those dollars to continue any earnings tax-free while held in the Roth.[1]

By contrast, the IRS requires individuals to begin taking minimum distributions from qualified retirement plans, like a 401(k), in the year in which they turn 70-1/2, whether or not they need the money. (The government figures it has waited long enough to collect on all those unpaid taxes). And there's a hefty penalty tax if minimum distributions are not made: the amount not withdrawn is taxed at 50 percent.

“Uncle Sam is very patient; he gives you a little deduction today in exchange for thousands of dollars in taxes down the road," said Coutu.

Not only do 401(k) required minimum distributions, RMDs, produce a hefty tax bill, but they also get counted as provisional income in determining the portion of your Social Security check that will be subject to taxation. Distributions from a Roth, which remember are not even mandatory, are not considered provisional income in Social Security calculations. "If you accumulate a lot of money in qualified plans, even if you are in the 15 percent tax bracket when you retire, your distributions may cause higher taxes," said Greg Hammer in an interview, chief executive officer of Hammer Financial Group in Schererville, Indiana.

For a growing number of retirees, said Hammer, RMDs elevate their tax burden. "One big misconception out there is that people think they'll pay less taxes in retirement, but the only way to pay less tax is if you have less income," he said. Hammer said Roth IRAs are also potentially better for surviving spouses. "When people retire, they often base their entire financial plan on a double income tax bracket, but after the first spouse dies, the person now in the single tax bracket hits the 10 percent, 15 percent and 20 percent brackets sooner," he said. "Roth IRAs not being taxed can prove to be more beneficial because even though you may be in a lower tax bracket when you retire, that may not be the case for the surviving spouse."

Roths Are More Flexible
Yet another benefit of a Roth IRA over a 401(k), not related to taxes, is their flexibility.

"Once money goes into your 401(k) forget it; it's buried until you are 59-1/2 unless you want to pay penalties and taxes," said Coutu, noting a few exceptions exist.

"If you put your money into a Roth instead, you can get your principal out any time you want tax-free." Note: The earnings from your Roth IRA cannot typically be withdrawn before age 59-1/2 without paying ordinary income taxes and a 10 percent early withdrawal penalty, but the IRS makes several important exceptions to that penalty – including for the purchase of a first-time home or college expenses for the account holder and his or her spouse, children, grandchildren or great-grandchildren.

Contribution Limits
There are limits, however, to how much you may contribute to a Roth IRA each year, and it is far lower than the limit for 401(k)s.

The total amount you can contribute to a Roth in 2016 is $5,500 unless you are over age 50, in which case you can contribute an additional $1,000 for a total of $6,500.
By comparison, employees may contribute up to $18,000 per year to their 401(k)s, plus an additional $6,000 for those 50 and older. (Some employers now also offer a hybrid Roth 401(k), which also allows you to save up to $18,000 in after tax contributions, but like a traditional 401(k), Roth 401(k) account holders are required to take RMDs when they turn 70-1/2, which triggers a taxable event.)

If, after contributing enough to your 401(k) to get the employer match and fully funding your Roth IRA, you still have retirement savings left to invest, Coutu suggests circling back to your 401(k) and maxing it out.

Click here to estimate your monthly income during retirement.
What If I Don't Qualify?

The 401(k)/Roth IRA savings strategy, however, has one big flaw: not everyone qualifies for a Roth.

Indeed, you can only contribute if your income falls below a certain threshold: Married couples who file jointly with modified adjusted gross income (MAGI) of less than $184,000 can contribute up to the annual limit. They can contribute a reduced amount until their MAGI reaches $194,000, at which point they are no longer eligible for a Roth IRA.

Single filers with MAGI of less than $117,000 can contribute the full amount to a Roth IRA; they can make a reduced contribution until their MAGI income reaches $132,000, and nothing at all when their MAGI exceeds that amount.
"If you are young and successful, you can't contribute to a Roth forever so take advantage of it while you can," said Coutu.
Those who do not qualify for a Roth IRA can look at another option to supplement retirement income down the road … a dividend-paying, cash value, whole life insurance plan, said Daniel Blake in an interview, president and chief executive officer of Southtowns Financial Group in Orchard Park, New York.

Such whole life insurance plans first and foremost offer a death benefit and cash value component. All internal growth is fully tax-deferred and the death benefit is tax free. Also, there are no requirements for withdrawals at a certain age. Dividends, while not guaranteed, can offer additional value in policies that qualify for them.

"You can take cash dividends, if any, up to your (cost) basis and borrow after your basis is met," said Blake, noting cost basis generally refers to the amount of premiums you have paid into the policy less any dividends or withdrawals you may have taken. "Withdrawals are tax-free and do not have to be paid back during your lifetime as long as you manage your debt to equity ratio."

While life insurance plans offer some important potential benefits, however, they are not intended to replace retirement savings, but rather as a retirement supplement. Those saving for retirement should carefully consider their needs and consult their financial professional for guidance.

Roth IRA Contribution Discipline
One final note: The 401(k)/Roth IRA savings strategy is predicated on discipline. Automated payroll deposits to your 401(k) make saving a cinch, whereas taking money out of your paycheck to fund your Roth IRA requires a more proactive investor.

If you don't trust yourself to make it happen, then stick with a strategy of maxing out your 401(k) – which still offers excellent tax-deferral benefits.

Those who have the resolve, however, may thank themselves later for biting the tax bullet today.

"If you are talking to younger investors, the likelihood of them accumulating enough in their traditional IRAs and 401(k)s to produce a significant tax burden is much greater," said Hammer. "If you divert to a Roth now, along with matching 401(k) dollars, you're just going to have that much more flexibility down the road."