Marc A. Hebert's 'Money $ense': Should you make pre-tax, Roth, or after-tax contributions?

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IN REVIEWING your employer-sponsored retirement savings plan, you may have noticed that you have some options for making your contributions.

You could have the option to choose to save on a pre-tax basis, make Roth contributions, or make after-tax contributions. So which one should you choose?

The answer depends on your individual situation. Let's examine each choice.

When making a pre-tax contribution, you are essentially opting for a tax benefit now versus later. Each contribution is deducted from your paycheck before any income taxes are taken out. This reduces your taxable income and the taxes that are due currently.

For example, let's say that you earn $2,000 bi-weekly. If your top marginal tax bracket was 25%, you would expect to pay $500 of taxes on the $2,000.This would net you $1,500 in take-home pay.

Say you decide that a 10% contribution to your retirement plan is a good idea.

At 10%, you would be making a contribution of $200.

Keep in mind that since this is a pre-tax contribution, you would now have taxable income of $1,800 instead of $2,000. Your taxes are now $450. This nets you $1,350 in take-home pay (calculation: $2,000 — $200 — $450). So in the second paycheck example, you have saved $200 for retirement while reducing your take-home pay by only $150.

Of course, this example is extremely simplified, but it illustrates the point.

An additional benefit of pre-tax contributions is that the earnings grow tax-free. However, the government doesn't allow this tax-free ride to last forever — at a certain point you must start taking distributions from the pre-tax account.

Keep in mind that these distributions are taxable. If you take the distribution too early, there is a 10% premature distribution penalty.

The next option we will examine is a Roth contribution.

Roth contributions are made with after-tax money. This means there isn't a tax benefit now by making the contributions.

The benefit comes later. Earnings on the Roth contributions are tax-free. Plus, once you take funds from the Roth account, you don't pay any taxes on the funds if you meet certain rules. These nontaxable amounts are considered "qualified" distributions.

Currently qualified distributions are those meeting a five-year holding period and are made upon death, disability, or reaching age 59½.

Unlike pre-tax contributions, there are no rules that say you have to take the money out unless you are saving in a Roth 401(k).

Your retirement plan could also have an after-tax option that allows you to make additional contributions.

This is helpful for those who want to put money into the retirement plan above and beyond the current annual limit (for 2020, the limit is $19,500 with an additional $6,500 contribution available for those age 50 and over).

The earnings on the account grow tax-deferred. If this option is offered, keep in mind that the total employee and employer contributions can't exceed $57,000 or $63,500 if you are over age 50.

Once you leave your job or retire, after-tax 401(k) contributions may be rolled over tax-free to a Roth IRA to potentially continue the tax benefit.

Which contribution type you choose depends somewhat on your tax bracket.

If you feel you are going to be in a lower tax bracket once you retire, then the pre-tax contribution might be the way to go.

This reduces your taxes now.

If you feel you are going to be in a higher tax bracket in retirement, then the Roth or after-tax contribution might be appropriate.

You could also consider making a combination of pre-tax and after-tax contribution to provide some flexibility in making distributions down the road.

As it can be difficult to know what elections to make when reviewing your retirement plan, consider asking a certified financial planner or another retirement professional for advice on reviewing your options.

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