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# Traditional or Roth?

## Modern retirement monthly

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- Retirement accounts can allow you to manage your tax burden during your working years and in retirement. By spreading your taxable income more equally over time, you can keep more of your income in lower marginal income tax brackets and improve the after-tax growth of your retirement savings.
- When saving in a retirement account, you have two main choices. A **Traditional deductible contribution** can reduce your income taxes now, but is taxable upon distribution in retirement. A **Roth contribution** is not deducted from your taxable income now, but contributions and growth are generally tax-free upon distribution in retirement.
- For most families, a balance of Traditional and Roth contributions will provide the best results. However, this doesn't mean that you should contribute to both types of accounts equally each year—you should redirect your contributions as your circumstances change.
- In this report, we provide an overview of Traditional and Roth 401(k) accounts, highlighting key factors that you should consider when deciding where you will direct your hard-earned savings.

Our new monthly podcast series focuses on topics that help families understand the basics of investing and financial planning at three different levels of depth (Definition, Identification, and Implementation). On this episode, we explain the differences between Traditional accounts and Roth accounts, including considerations when it comes to contributions, frequency of account reviews, and taxes: 3-Levels Podcast: Considerations for Traditional v. Roth accounts.

There's a reason many Americans hold the bulk of their retirement savings in 401(k) accounts: These accounts provide an opportunity for tax-deferred growth that compounds over time.

There are two main types of 401(k) contributions:

1. **Traditional deductible contributions:** Contributions are made on a pre-tax basis, investment earnings grow tax-free, and distributions taken in retirement are taxed at ordinary income tax rates.
2. **Roth contributions:** Contributions are made after income taxes are withheld, investment earnings grow tax-free, and qualified distributions are also free of income tax.[1] Most 401(k) plans—but not all of them—offer a Roth contribution option. Unlike Roth IRA contributions, Roth 401(k) contributions are not subject to restrictions based on your income level.

In this report, we provide an overview of the key differences between Traditional and Roth 401(k) accounts and discuss key considerations to help you through the decision-making process.

It's important to note that we will be focusing primarily on 401(k) plans in this report, but you may be able to make Traditional or Roth contributions to other types of retirement accounts, such as a 403(b), 457 plan, or IRA.

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Each account type has different rules regarding eligibility to contribute, contribution limits and restrictions, and distribution requirements.

## What's the difference between a Traditional and Roth 401(k)?

**#1. Tax treatments**

When you make a contribution to a Traditional 401(k), it is taken from your paycheck before income taxes are calculated and taken out, meaning the contribution will reduce your taxable income for that tax year. These pre-tax dollars will grow in your account untaxed until you withdraw them (and the investment growth they created) in retirement, at which point they will be taxed as ordinary income. So contributions to a Traditional 401(k) can help you reduce your current taxable income, but they will also increase your taxable income in the future. In other words, every tax-deferred dollar represents a future tax burden.

Figure 1 - The biggest difference between these accounts is when the dollars are taxed

Tax treatments for assets in a Traditional and Roth 401(k)

| | Traditional 401(k) | Roth 401(k) |
|---|---|---|
| Contributions are pre-tax | ✓ | |
| Investment earnings grow tax-deferred | ✓ | ✓ |
| Qualified distributions are tax-free | | ✓ |

Source: UBS. See endnote #1 for the definition of a qualified distribution.

When you make a contribution to a Roth 401(k), it is taken from your paycheck after the taxes have been paid, so there is no tax benefit or savings in the year the contribution is made. These after-tax dollars will grow in your account untaxed. In retirement, your contributions and the investment growth they created can be withdrawn free of income tax.[1] Thus, contributions to a Roth 401(k) will not reduce your current taxable income, but they help you generate tax-free growth and income in retirement.

All things being equal, the timing of taxes will not have an impact on the after-tax growth of your retirement account assets. If your tax rate at the time of contribution is the same tax rate at the time of distribution, then you will have the same amount of after-tax wealth.

**#2. Required minimum distributions**

Required minimum distributions (RMDs) are withdrawals that you have to take from certain retirement accounts beginning at a certain age.

Like other retirement account withdrawals, RMDs from Traditional retirement accounts are typically taxed as ordinary income, regardless of whether you are spending the funds or reinvesting them.

RMDs can be especially problematic if you have a larger balance in your Traditional retirement accounts, because larger balances lead to larger distributions which can push your income into a higher tax bracket, dampening the after-tax growth potential of your retirement accounts.

Unlike Traditional retirement accounts, Roth accounts are not subject to annual RMDs.[2] As a result, Roth account dollars can benefit from a longer investment horizon, allowing for more tax-free growth potential. At the same time, you can use Roth account tax-free distributions to fund a greater share of your retirement spending in years when you are in a high income tax bracket or if you're looking to defer realizing capital gains taxes in your taxable accounts.

**#3. Wealth transfer considerations**

Traditional and Roth assets will generally maintain their tax treatment when passing to non-spouse beneficiaries, such as your children. At the same time, your taxable (i.e., non-retirement) accounts will receive a step-up in cost basis, essentially "forgiving" the capital gains taxes on unrealized gains in those accounts.

Beneficiaries who inherit Roth accounts will be able to withdraw assets without triggering income taxes,[3] while distributions from inherited Traditional accounts will be taxed at the beneficiary's income tax rate.

The fact that Traditional account distributions will add to your beneficiary's taxable income is exacerbated by the fact that most non-spouse beneficiaries who inherit the account on or after 1 January 2020 must abide by a "10-year rule":[4]

- If the account owner died on or after their required beginning date (RBD),[5] the beneficiary must take annual RMDs in years 1–9 following the original owner's death. These annual distributions in years 1–9 do not apply to Roth accounts that are otherwise subject to the 10-year rule, because Roth assets are not subject to lifetime RMDs.[2]
- Regardless of whether the original account owner died on or after their RBD, all assets must be withdrawn by 31 December of the year containing the 10th anniversary of the owner's death.[4]

It's important to understand whether your retirement accounts will be subject to estate taxes. The federal lifetime gift and estate tax exemption for 2024 is $27.22 million per married couple in 2024, but this exemption is scheduled to fall to approximately $14 million per couple starting in 2026.

To the extent that your estate is large enough to be subject to federal estate taxes (or, indeed, to state-level estate and inheritance taxes!), Roth assets are a superior asset to leave to your beneficiaries.[6] Consider these two examples, where each family has used their lifetime gift and estate tax exemptions for transferring other assets:

- Family 1 has $1,000,000 in a Traditional retirement account and $1,000,000 in a taxable investment account, and thus reports $2,000,000 of assets on the estate tax return.
- Family 2 has $1,000,000 in a Roth retirement account and $650,000 in a taxable investment account ($350,000 was used to pay for a Roth conversion at a 35% tax rate), and thus reports $1,650,000 of assets on the estate tax return.

For additional considerations when deciding which assets to prioritize for wealth transfer objectives, please see [Which assets are better to use in retirement?]

## Three questions to consider

**#1. How does your current tax rate compare to the tax rate you will face in retirement?**
If you're choosing to contribute to a Traditional or Roth 401(k) account, the most important consideration is your tax rate today, and how it compares to the tax rate those dollars will face when they are distributed.

When comparing your income to the federal tax brackets (see 2024 Tax fact sheet), please don't forget to consider your deductions and the impact of state income taxes now and in retirement.

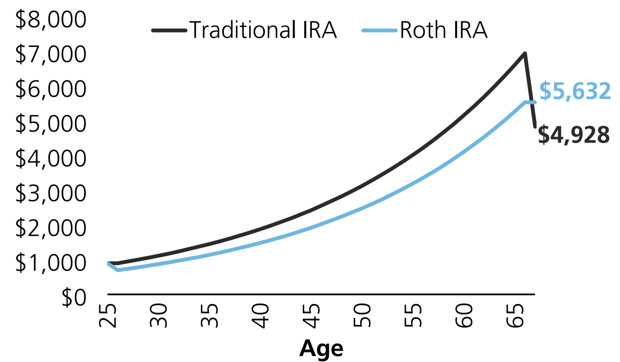
It's likely that Congress will increase income tax rates—especially on high-income families—to address the country's significant debt burden. Even so, changes to the tax brackets are only one part of the equation—your family's taxable income will likely change significantly from year to year, which may move you in and out of marginal income tax brackets such that you may want to change your contribution strategy accordingly.

Every family's income trajectory will be different, but here are some common patterns that we see:

During your **early working years**, your taxable income will likely be low, so making contributions to a Roth 401(k) account—paying taxes today at a lower rate, instead of deferring them to retirement when you may be taxed at a higher rate—will often be the best strategy to reduce the tax burden on these dollars.

Figure 2 - If your tax rate will be **higher** in retirement, we generally recommend a **Roth contribution**

Hypothetical growth of a $1,000 contribution deposited at age 25, assuming 5% annual growth, a 20% tax rate at the time of the contribution, and a 30% tax rate at age 65 when the assets are distributed

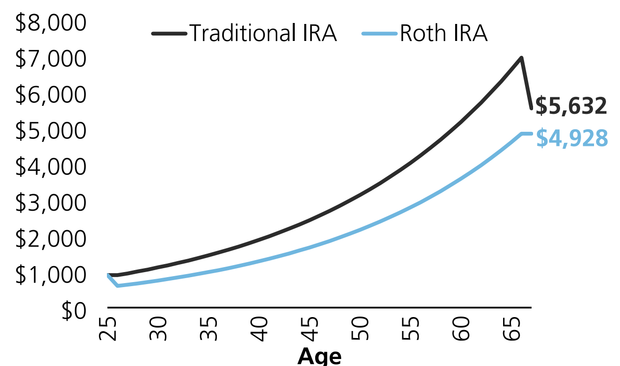



Source: UBS. For illustration purposes only.

**Later in your career**, as your taxable income grows, it will push you into higher tax brackets. If you expect to be in a lower tax bracket in retirement, making pre-tax contributions today will allow you to defer the tax cost of those dollars until retirement when you may be taxed at a lower rate.

Figure 3 - If your tax rate will be **lower** in retirement, we generally recommend a **Traditional contribution**

Hypothetical growth of a $1,000 contribution deposited at age 25, assuming 5% annual growth, a 30% tax rate at the time of the contribution, and a 20% tax rate at age 65 when the assets are distributed




Source: UBS. For illustration purposes only.

Last, but not least, your taxable income will likely be lower in **early retirement**, before you start to receive taxable income from your RMDs, pension, annuity, and Social

Security. During these years, you may want to use any earned income to make further Roth contributions. This is also a period where you may want to implement partial Roth conversions.

**#2. How much wealth do you currently have saved in taxable, tax-deferred, and tax-exempt assets?**
As you think about whether to contribute on a Traditional or Roth basis, it's also important to consider the tax treatments of your existing assets.

Traditional retirement accounts will add to your taxable income in retirement when you tap them for spending (and when RMDs begin). The more you contribute to Traditional retirement accounts, and the more that you grow these assets, the greater your taxable income will be in retirement. Over-investing in a Traditional IRA or 401(k) today may actually increase your overall tax burden and could reduce your after-tax wealth in retirement.

While there's no optimal ratio of taxable, tax-deferred, and tax-exempt assets that you should target, spreading your assets across each tax treatment can help you decide how much taxable income and investment income you will have in a given year, allowing you to manage your tax burden more dynamically throughout retirement.

Even if you're in a high income tax bracket today, adding more tax-exempt assets to your balance sheet may still be beneficial if the bulk of your wealth is saved in tax-deferred assets. While it might not save you directly on expected taxes, it could help you improve your tax diversification and protect yourself against potential tax increases in the future.

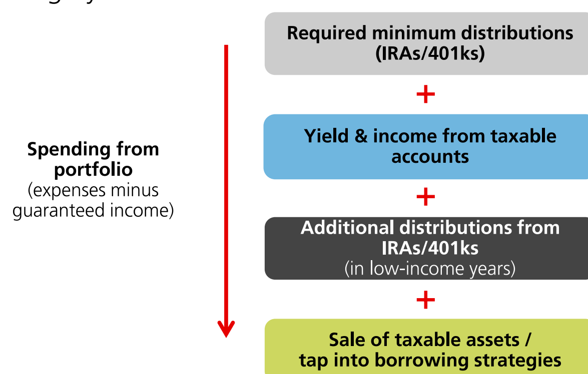
It's important to note that if you've received a matching contribution from an employer prior to 2023, these contributions were made on a pre-tax basis even if your own contributions were Roth. As a result of SECURE 2.0 Act, employers with defined contribution plans are now allowed to provide participants with the option of receiving matching contributions on a Roth basis.

If your employer chooses to give you the option for matching contributions to be made on a Roth basis, this can help you get more tax-exempt dollars on your balance sheet.

For more information on SECURE 2.0, please see our [2024 Retirement guide].

**#3. Will this contribution (and its growth) be earmarked for lifetime spending, or will they pass to your beneficiaries?**
In retirement, we recommend using the "Spending waterfall," which will help to manage your income tax burden and defer capital gains taxes.

Figure 4 - The "spending waterfall" can help you manage your taxes in retirement




Source: UBS.

If you are making a contribution that you believe will be left for your beneficiaries to inherit (e.g., your Legacy strategy), you should bear in mind a few key considerations caused by the "10-year rule" (see the "Wealth transfer considerations" section, above):

- If you have many heirs, you may be able to lessen the income tax burden for each (and the family as a whole) by spreading your Traditional retirement account assets among several beneficiaries (especially if they are already in a lower income tax bracket when they inherit their share of your retirement account).
- If you do not have many heirs, it's likely that a Traditional contribution could increase your family's tax burden more than a Roth contribution, especially if your beneficiaries are already in a high income tax bracket when they inherit your Traditional retirement account.[7]

Traditional and Roth retirement accounts have a common tax advantage: Their returns are not subject to the tax drag from dividend, income, and capital gains taxes. However, once you reach the required beginning date for making RMDs, there is a divergence: Roth account investment earnings continue to grow without this annual tax drag, but Traditional account distributions (now reinvested in taxable accounts) will now be subject to these taxes.

As a result of this tax drag, we find you will be better off contributing to a Roth account if you are intending to leave the assets for inheritance. We will review a case study of this in the Appendix section.

For more information, please see "[Beyond RMDs: Strategies for IRA owners and beneficiaries]."

## Next steps

With so many variables that factor into an individual's tax liability, it can be difficult to determine what the right

strategy looks like for your situation. Add in the fact that there's no way to know with certainty what the future holds for tax rates, and this decision-making process is complicated even further.

Building your savings and retirement strategies around maximizing flexibility can be far more effective than strategies that rely on an accurate forecast of tax rates. And many investors are already building flexibility simply by saving across a mix of taxable, tax-deferred, and tax-exempt accounts.

When tax diversification is paired with a dynamic "decumulation" strategy in retirement—in which the retiree draws from their retirement funds in whichever sequence is more tax-efficient (taxable, tax-deferred, or tax-exempt)—investors can effectively manage their liabilities without compromising on meeting their goals if tax rate changes differ from expectations.

**#1. Enhance flexibility by diversifying tax treatments**. During your working years, prioritize your savings based on after-tax growth potential. Ideally, you will be able to spread your investments across a mix of tax treatments (taxable, tax-deferred, and tax-exempt), which will give you more options for managing the timing of your taxable income and realized capital gains in retirement. Our 2024 Savings waterfall worksheet provides a good tool for evaluating this on a year-by-year basis, including a summary of the limits for 2024 contributions.

**#2. Consider completing partial Roth conversions during lower-than-normal income tax years**. If you have lower-than-normal income one year, you may have an opportunity to complete Roth conversions at a lower tax cost by transferring a portion of your Traditional IRA/401(k) to a Roth IRA/401(k).[8] The dollar amount of your Roth conversion will count as taxable income, so conversions in low-tax years are a great way to fund tax-exempt assets that will continue growing, won't be subject to lifetime RMDs, and will pass income tax-free to your beneficiaries. For more information, please "Beyond RMDs: Strategies for IRA owners and beneficiaries."

**#3. Revisit your contribution type annually**. For most families, a balance of Traditional and Roth contributions will provide the best results. However, this doesn't mean that you should contribute to both types of accounts equally each year—you should redirect your contributions as your circumstances change.

As we discussed in the "How does your current tax rate compare to the tax rate you will face in retirement?" section above, we generally recommend making Roth 401(k) contributions earlier in your career when your taxable income is low, and when your taxable income is higher later in your career, we suggest making Traditional 401(k) contributions.

There isn't an income level at which point every family should shift from Roth to Traditional. However, you should revisit your contribution type any time you move into a higher tax bracket because there is a greater chance of being in a lower tax bracket in retirement. And, since the largest jumps in our income tax system occur when moving from the 12% to 22% bracket and the 24% to 32% bracket, these are the two points where making the switch from Roth to Traditional may provide you with greater tax savings.

We suggest revisiting your contribution type annually and any time your tax situation changes (e.g., when you get a raise, your filing status changes, or if you move to a state with a higher or lower income tax rate). And don't forget about the standard deduction when figuring out where the threshold is for you.

## Appendix: Other strategies to add more Roth dollars to your balance sheet

**Roth conversions**: If you aren't able to *contribute* to a Roth account, you can still add more Roth dollars to your balance sheet via Roth *conversions*. As with Roth contributions, you will need to pay income taxes on any tax-deferred assets that are converted to a Roth account.

A full Roth conversion—where you convert all of your tax-deferred assets at once—in a single year would be ill-advised, in our view, generating a lot of taxable income that could be taxed at a higher tax rate. Instead, we generally recommend implementing partial Roth conversions—converting a small amount each year—in order to smooth taxable income out across as many years as possible.

To maximize the potential benefits of a Roth conversion, we suggest using other assets to pay the tax cost, rather than using the IRA assets. This allows you to keep more of your money in Roth IRA where it can grow tax-free.

**Backdoor Roth from a Traditional IRA**: With a backdoor Roth, you make an after-tax contribution to an IRA, up to the annual contribution limit ($7,000 in 2024, $8,000 if you're age 50 or older), then immediately convert the funds into a Roth IRA. This strategy allows those with higher incomes to leverage a Roth account even though their income is too high for direct Roth IRA contributions.

It's important to note that the pro-rata rule applies to Roth IRA conversions, so if your Traditional IRA contains both pre-tax and after-tax dollars, your Roth conversion will be taxed proportionate to that ratio.

The pro-rata rule encompasses all of your IRAs (including rollover IRAs, SEP-IRAs, and SIMPLE IRAs), not just the account or portion of the account that you're converting to a Roth IRA.

Therefore, in order to limit or avoid taxes on the conversion that would result from the application of the pro-rata rule, you must:

1. Not have any other IRAs that contain pre-tax assets at any point during the year of the conversion.
2. Initiate the conversion immediately after making the non-deductible contribution to avoid earnings accruing on the contribution. By converting immediately, you avoid (or limit) having to pay taxes on the conversion.

**Mega backdoor Roth with a 401(k)**: Making after-tax contributions to your 401(k) plan and then promptly converting those funds to a Roth account is known as the mega backdoor Roth strategy. "Mega" refers to the higher contribution that is allowed in 401(k) plans, relative to IRA contribution limits.

Figure 5 - How much you can convert via a mega backdoor Roth depends on your plan

Hypothetical example of the amount an individual can convert via a mega backdoor Roth in their 401(k) plan, assuming an $8,000 employer matching contriubtion

| | |
|---|---|
| Total IRS contribution limit: | $69,000 |
| – 401(k) contribution limit: | – $23,000 |
| – Your employer's matching contribution: | – $8,000 |
| **How much you can convert via a mega backdoor Roth:** | **$38,000** |

Source: UBS. For illustration purposes.

Not all 401(k) plans offer a Roth 401(k) option, and they also might not offer the option to contribute on an after-tax basis. Additionally, 401(k) plans are not required to permit in-plan Roth conversions. Please consult with your 401(k) plan provider to learn more about your options that relate to this backdoor Roth strategy.

**529 roll over to Roth IRA**: Beginning in 2024, the owner of a 529 account that's been opened for more than 15 years can transfer up to $35,000 (lifetime limit per beneficiary) from that account to a Roth IRA for the 529's beneficiary (not the account owner's Roth IRA).

It's important to note that the amounts contributed to the 529 in the past five years and their earnings are ineligible to be rolled over.

Additionally, the beneficiary must have earned income that year and these rollovers will be subject to Roth IRA annual contribution limits. This means that you can only roll over an amount up to that year's contribution limit, less any other IRA contributions you make that year. However, unlike regular Roth IRA contributions, eligibility to complete this rollover will not be affected by the beneficiary's income level.

Given these limitations, we do not suggest deliberately overfunding your 529 plan to take advantage of this provision. However, families now have another option to help some of their leftover 529 assets to avoid being taxed or penalized upon distribution.

For more information, please see "529 College Savings FAQ."

## Appendix: Case study

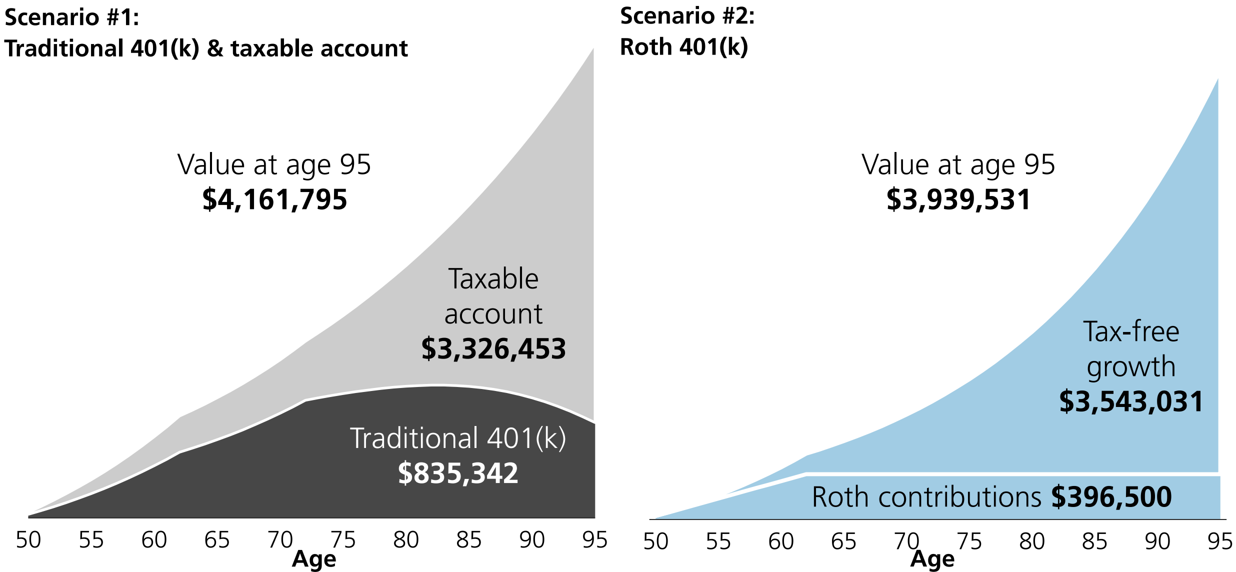
In this hypothetical case study, we consider two scenarios where an investor is allocating $48,413 of their earned income toward investment accounts from age 50 to 62, and then keep the funds invested until age 95—at which point they are inherited by beneficiaries.

In Scenario 1, contributions go toward a Traditional 401(k) and a taxable investment account; in Scenario 2, the contributions are allocated to a Roth 401(k) account.

## Results

Figure 6 - Taxes can be a modest drag during your lifetime

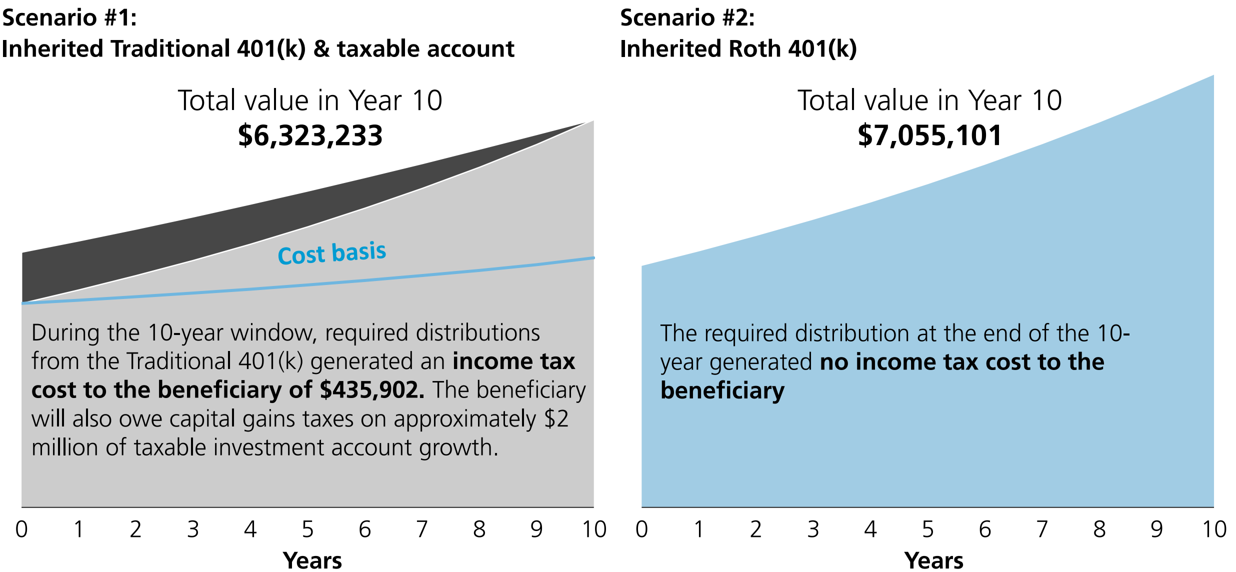
Growth of a Traditional 401(k) and taxable account, and a Roth 401(k) during two hypothetical investors' lifetimes




Source: UBS. For illustration purposes.

Figure 7 - Tax drag can make an even bigger impact for heirs

Growth of a Traditional 401(k) and taxable account, and a Roth 401(k) inherited by two hypothetical non-spouse beneficiaries who are subject to the 10-year rule




Source: UBS. For illustration purposes only.

## Assumptions

Scenario #1:
**Traditional 401(k)**

- $30,500 annual contribution (regular + catch-up) from ages 50–62
- RMDs begin at age 73 and continue until age 95
- 37% tax rate on distributions to account owner as well as their beneficiaries

- Annual growth rate: 6%
- During the 10-year window following the account owner's death, distributions made with this formula: (Account value ÷ years remaining). In other words, 1/10th in Year 1, 1/9th in Year 2, etc.

**Taxable account**

- Contributions to the Traditional 401(k) are deductible from income taxes that year, so we invest the tax savings ($17,913, assuming a 37% tax rate) in a taxable account
- During retirement, required minimum distributions (net of the RMD tax cost) from the Traditional 401(k) are added to the taxable account and reinvested
- Annual growth rate: 5%

Scenario #2:
**Roth 401(k)**

- $30,500 [$48,413 x (1 – 37%)] annual contribution (regular + catch-up) from age 50–62
- No lifetime required minimum distributions
- Annual growth rate: 6%
- Following the account owner's death, we do not distribute any funds until the end of Year 10, in order to extend the period of tax-free growth

# Endnotes

[1] A qualified distribution from a designated Roth account (i.e., Roth 401(k), 403(b), or 457 plan) is generally a distribution made from an account that has been held for at least five years (see endnote #3 for more information regarding the five-year rule) and is either made on or after the date you attain age 59½, made after your death, or attributable to your being disabled. A qualified distribution from a designated Roth account is not included in your gross income.

[2] Starting in 2024, RMDs are no longer be required from designated Roth accounts (i.e., Roth 401(k)s). Note: Roth IRAs have never been subject to RMDs.

[3] You cannot withdraw earnings from a Roth retirement account on a tax-free basis until at least five years after the first contribution to that Roth account. The clock starts ticking on 1 January of the tax year when the first contribution was made. Failure to follow the five-year rule can result in paying income taxes and a 10% penalty on any earnings that are withdrawn.

[4] There are a few exceptions to the 10-year rule for inherited 401(k)s and IRAs. In addition to spouse beneficiaries, the 10-year rule doesn't apply to beneficiaries who at the time of the 401(k) or IRA owner's death are disabled or chronically ill; it does not apply to minor children of the 401(k) or IRA owner (in which case the 10-year rule applies when they reach the age of majority, defined as age 21 per proposed regulations issued by the IRS); and it also does not apply to those who are not more than 10 years younger than the account holder (e.g., slightly younger or older siblings).

[5] The required beginning date (RBD) is April 1 of the year after the year the 401(k) or IRA owner attains their applicable RMD age (70½ for individuals who attained age 70½ before 2020; 72 for individuals who attained 70½ in 2020 or after; 73 for individuals who attain 72 in 2023 or later; and 75 for individuals who attain 73 in 2033 or later).

[6] Due to the "Income in Respect of a Decedent" (IRD) deduction, Roth conversions may not ultimately have an impact on your family's federal estate tax burden. Using the IRD deduction, beneficiaries may be able to deduct any estate taxes that are attributable to inherited Traditional retirement accounts from the income that they report on taxable distributions from those accounts. Many states do not have an IRD deduction. On the other hand, state estate and inheritance tax rates may be lower than the tax rate due on a Roth contribution or conversion, so each family should weigh these considerations when making a decision.

[7] Theoretically, you can improve the tax efficiency of your inheritance by leaving more Traditional retirement account assets to low-income family members, and more Roth and taxable account assets to high-income family members. At the same time, this can lead to some complicated logistics. Designating a trust as your beneficiary can help to make it easier to effectively apportion the inheritance shares. However, this can lead to additional considerations. For example, if the beneficiaries of the trust include both eligible designated beneficiaries (EDBs) and non-EDBs, the trust will generally be subject to the 10-year rule while if the beneficiaries were all EDBs, they could take distributions over their life expectancy. We recommend that you review your retirement account beneficiaries frequently.

[8] Not all 401(k) providers allow to participants to implement an in-plan Roth conversion. If they do not, you may need to roll your 401(k) into an IRA in order to implement the Roth conversion. Please refer to the UBS IRA Rollover Guide, available here, for key considerations prior to deciding whether to roll your 401(k) to an IRA.

# Appendix

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