Traditional (Pre-Tax) vs. Roth (After-Tax) Contributions

The primary difference between a Traditional (pre-tax) and a Roth (after-tax) contribution type is when one chooses to pay the income tax. With a Traditional contribution, a participant defers the income tax owed on that contribution until the money is cashed out. For Roth contributions, the participant elects to pay the income tax before it is deposited to their retirement account. There are pros and cons to both contribution types. **By offering both types, a plan sponsor can provide their participants more flexibility to manage the tax liability of the retirement savings benefit in a way that best fits their individual financial profile and goals.**

Traditional (Pre-Tax)

- The Traditional contribution was designed to encourage employees to save by lessening the impact of that saving on their bottom line now. Because the contributions are made pre-tax, a $100 contribution/check, will only reduce the take-home pay by about $70-80 depending on the employee's tax bracket. In this way, the Traditional method reduces the employee's taxable income now.
- Traditional contributions grow tax-deferred. This simply means that until the money is cashed out of the account, the earnings from the account are not taxed as they would be in a taxable account. This keeps more money invested and allows the account to grow larger over time.
- Traditional contributions and their accumulated earnings are taxed as regular income when they are cashed out. The assumption behind this method is that if the individual truly waits until they are retired or no longer working full-time, then their annual income – and therefore their tax bracket – will be lower. So, even though taxes are owed, they would theoretically be at a lower tax rate than when the employee was working full-time.

Roth (After-Tax)

- The Roth contribution does not provide the up-front savings of the Traditional contribution. Unlike the above example, a $100 contribution/check reduces the take-home pay by a full $100. They do not provide any reduction in one's taxable income at the time of the contribution.
- As long as the account has been open for at least 5 years and the employee is age 59½ or older, any money cashed out from the account is tax-free. In this way, the Roth contribution allows the employee to avoid taxes on any earnings the account has accumulated. Roth contributions tend to be more advantageous to younger employees as the longer the money is invested, the more potential earnings may accumulate.
- For employees of any age, however, the Roth contribution may be chosen if they believe that their current tax rate is lower than it will be when the account is cashed out. Finally, should some emergency expense arise in retirement or after leaving the employer, the Roth contribution can provide employees the ability to use their retirement savings without incurring the same tax liability as Traditional retirement savings.

Additional Notes

- For both Traditional and Roth contributions, cash distributions made before the employee has reached age 59½ are subject to the IRS' Early Withdrawal Penalty of 10%. Traditional contributions are fully subject to the penalty, while only the earnings from Roth contributions are subject to the penalty.
- Employer contributions are always made on a pre-tax basis regardless of the type of contribution(s) made by the employee.