

# Pre-Tax vs. After-Tax Retirement Contributions: Which Plan Is Better for You?

When it comes to saving for retirement, there are two main ways you can contribute: through pre-tax and after-tax contributions. But which plan is better for you? It all depends on your individual situation and goals. In this blog post, we'll discuss the differences between pre-tax and post-tax retirement contributions to help you determine which option best meets your needs. Read on to learn more!

## What Is a Pre-Tax Retirement Plan?

A pre-tax retirement plan is one that you pay into using income that hasn't been taxed yet. That means the contribution is taken directly out of your paycheck before taxes have been calculated, reducing your taxable income as a result. Funds contributed through a pre-tax retirement plan grow tax-free until they are withdrawn in retirement, at which point they'll be subject to income tax.

Some of the most commonly used pre-tax retirement plans include:

- **401(k) Plans:** This is a type of retirement savings plan sponsored by an employer. Employees can contribute a portion of their salary on a pre-tax basis, up to a certain annual limit set by the IRS. Employers can also make matching contributions to the plan on behalf of employees.
- **403(b) Plans:** Similar to a 401(k), a 403(b) plan is a retirement savings plan for employees of tax-exempt organizations and public schools.
- **457 Plans:** A 457 plan is a type of retirement savings plan similar to the 401(K) that's offered by state and local governments and some non-profit organizations.
- **Traditional IRA:** A traditional Individual Retirement Account (IRA) allows individuals to contribute pre-tax dollars, up to an annual limit set by the IRS.
- **Simplified Employee Pension (SEP) IRA:** This is a retirement plan for self-employed individuals or small business owners. The plan allows the employer to make contributions to an employee's retirement account on a tax-deductible basis.
- **SIMPLE (Savings Incentive Match Plan for Employees) IRA:** A SIMPLE IRA is a retirement savings plan for small businesses. It allows employees to contribute pre-

tax dollars, and employers are required to either match those contributions or make a fixed contribution.

Pre-tax plans offer several advantages, with the biggest one being tax deferral. Because contributions are made before taxes are taken out, the amount of your overall income for that year decreases. This can drop you into a lower income tax bracket and greatly reduce your tax obligation.

Pre-tax plans also make it possible for your investments to grow faster with less tax liability. Any interest you earn in one of these investment plans will accumulate tax-free until you withdraw it. This means that the longer you keep your money in the account, the more you'll benefit from compound interest and the faster your savings will grow.

However, there is a significant drawback that needs to be addressed. Because you don't pay taxes on contributions before they're invested, you'll need to pay taxes on them later; this happens in retirement once you start withdrawing funds. Deferring taxes can result in a higher tax bill in retirement, especially if you've moved into a higher tax bracket than when you were making contributions.

## **What Is a Roth IRA?**

A Roth IRA is a retirement savings plan that allows investors to make tax-free withdrawals in retirement. Unlike traditional IRAs, contributions to a Roth IRA are made after taxes have already been paid. This means that when withdrawals are taken in retirement, they're not subject to income tax.

However, not everyone is qualified to contribute to a Roth IRA; there are income limits imposed by the IRS. Single filers can only contribute to a Roth IRA in 2023 if they have a modified adjusted gross income (MAGI) under \$153,000 while the threshold for spouse filing jointly is a combined MAGI of less than \$228,000.

## **Tax advantages of Roth IRA**

Contributing to a Roth IRA can provide several tax benefits, including:

### **1. Tax-free withdrawals in retirement**

The biggest advantage of a Roth IRA is that withdrawals made in retirement are tax-free, meaning you don't have to pay any taxes on the money you take out. This is because investments in a Roth IRA are made with after-tax dollars – you already paid tax on the income before you made the contribution.

### **2. Tax-free growth**

The funds in a Roth IRA grow tax-free, which means that you don't have to pay taxes on the earnings or gains made in the account.

### 3. No required minimum distributions

Unlike traditional IRAs and 401(k) plans, Roth IRAs do not have required minimum distributions (RMDs) after age 72. This means that you can keep your funds in the account for as long as you like and continue to let them grow tax-free.

### 4. Tax-free withdrawals for certain purposes

In addition to tax-free withdrawals in retirement, you can also withdraw funds from a Roth IRA tax-free and penalty-free under certain conditions, such as buying a first home, paying for qualified education expenses, or covering unreimbursed medical expenses.

## Pre-Tax vs. Roth (After-Tax) Contributions Comparison

The IRS sets contribution limits for both pre-tax and post-tax contributions, but they vary from plan to plan. In 2023, the contribution limits are as follows:

PLAN NAME	TYPE	CONTRIBUTION LIMIT (< AGE 50)	CONTRIBUTION LIMIT (AGE 50+)
401(k), 403(b), & 457 plans	Pre-tax	\$22,500	\$30,000
Traditional IRA	Pre-tax	\$6,500	\$7,500
SEP IRA	Pre-tax	25% of compensation or \$66,000	25% of compensation or \$66,000
SIMPLE IRA	Pre-tax	\$15,500	\$19,000
Roth IRA	After-tax	\$6,500	\$7,500

## How To Determine Which Plan Is Best for You

Deciding whether to contribute to a pre-tax retirement plan, a post-tax retirement plan, or a mix of both depends on several factors. Here are some considerations to keep in mind when making this decision:

**Your current tax rate:** If you're currently in a high tax bracket, contributing to a pre-tax plan can help reduce your taxable income and potentially lower your tax bill. On the other hand, if your current income falls within a lower tax bracket, you may want to prioritize contributions to an after-tax plan, like a Roth IRA, to take advantage of tax-free withdrawals in retirement.

**Your expected future tax rate:** It can be challenging to predict what your tax rate will be in the future, but if you expect to fall into a lower tax bracket when you retire, it makes sense to contribute to a pre-tax plan. If you expect to be earning more by the time you retire, contributing to an after-tax plan like a Roth IRA can help you avoid paying higher taxes on your withdrawals.

**Your retirement goals:** Your retirement goals can also play a role in deciding what type of plan to contribute to. If your goal is to maximize your retirement savings and reduce your tax bill in the short term, investing in a pre-tax account makes the most sense. If your goal is to have tax-free income in retirement, contributing to an after-tax plan like a Roth IRA may be the best strategy.

Ultimately, the decision of where to invest your retirement savings will depend on your individual financial situation, goals, and preferences. It's always a good idea to consult with a financial advisor or tax professional to help you make an informed decision.

## **It's Never Too Late to Start Retirement Planning**

Retirement planning is a critical part of financial security and stability. Knowing the difference between pre-tax and after-tax retirement contributions can help you make informed decisions when setting up a retirement plan.

No matter your age or stage in life, it's never too late to start planning for retirement. The [wealth management](#) team at Cadence Bank can help you understand the different retirement options available and guide you in making an informed decision that best suits your needs. [Contact us](#) today to get started on creating a solid retirement plan.