

# Roth 403(b) vs. Traditional 403(b)

## The MYTH BUSTERS



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# Myth 1

**Tax Advantage.** Roth is advantageous if the marginal tax rate after retirement for the employee is expected to be the same as or greater than the marginal tax rate before retirement.

# Myth 1 – False

Myth Buster. This myth is false.

- ❑ The comparison should be based on the marginal tax rate of the employee at the time of the contribution while working compared to the "blended" tax rate during retirement.
- ❑ If an employee anticipates that his taxable income at retirement will be the same or less than his taxable income at contribution, his “blended” effective tax rate at retirement will necessarily be less than his “marginal” tax rate at contribution and the value of the traditional 403(b) may be higher than the Roth.



## Myth 2

**A Roth 403(b) Provides a Mathematically Higher After-Tax Benefit Than a Traditional 403(b).** Popular Roth calculators show that, if tax rates do not change, the Roth 403(b) produces a higher after-tax benefit than a traditional 403(b).

# Myth 2 - False

**Myth Buster.** This myth is false.

- ❑ If an employee contributes the same amount (or % of pay) to either a Roth 403(b) or a traditional 403(b), they are mathematically equivalent.
- ❑ The comparison should take into account the Tax Savings on the traditional 403(b) contribution by assuming the employee invests the Tax Savings outside the plan.



## Myth 3

**State Taxes May Enhance Traditional 403(b).** Some states allow certain levels of retirement income to be distributed tax free thus lowering the blended effective tax rate of the employee during retirement.

# Myth 3 - True

Myth Buster. This myth is true.

- ❑ For employees in these states, the tax advantages for a Roth 403(b) are lessened.
- ❑ A lower tax rate after retirement favors a traditional 403(b) over a Roth.



## Myth 4

**Lump Sum Distributions Favor Roth.** If an employee plans on taking a lump sum distribution at retirement and paying tax at that time, a Roth 403(b) is almost always better than a traditional 403(b). The blended effective rate on a lump sum distribution is likely to be significantly higher than the marginal tax rate of the employee before retirement.

# Myth 4 - True

**Myth Buster.** This myth is true, but misleading.

- ❑ The blended effective tax rate at retirement on a lump sum distribution is likely to be higher than the marginal tax rate on the traditional 403(b) contribution if a lump sum taxable distribution is assumed.

## Myth 4 - But

- ❑ Even though this myth is true, it is misleading in that most retirees will not (should not) take a single lump sum taxable distribution at retirement, especially ministers with housing costs in retirement.
- ❑ A more realistic assumption is that the employee will take periodic distributions, e.g., for life.
- ❑ The result is that the “blended” effective tax rate on distributions is likely to be less on the traditional 403(b) distribution than the “marginal” tax rate on the original taxable Roth contribution.



# Effect of Housing Allowance

- ❑ No myth here
- ❑ Very difficult for ROTH to overcome tax advantage of Traditional 403(b) for minister claiming a Housing Allowance after retirement



# Effect of Housing Allowance - But

- ❑ But what if retired minister has significant other taxable income
  - For example he continues to work and draw a retirement benefit
  
- ❑ SURPRISE – another myth debunked



## Bottom Line:

- ❑ No simple answers because comparisons depend on a number of assumptions: current income, retirement income, state taxes, current tax rates, future tax rates, longevity, rates of return, etc.

# Some examples of advantageous Roth 403(b) fact patterns:

1. An employee anticipating a significant increase in his blended effective tax rate after retirement compared to his current marginal tax rate.
  - For example a higher retirement income than working career income
2. A longer contribution period (30 years plus) so that there is a higher retirement income than working career income may favor Roth 403(b).
3. An aggressive investor who expects a high rate of return (and thus higher retirement income than working career income) may favor a Roth 403(b).
4. A family planning opportunity for lower paid children.
5. A wealthy employee who does not intend to spend any of his Roth 403(b) account during his lifetime, could use a Roth 403(b) as an estate planning technique.

# Questions



Roth Calculator can be accessed at:  
<https://imremote.icemiller.com/RothCalc/default.aspx>