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Change is Coming to Your 401k Contribution Tax Status

High earning workers are about to lose tax deductibility for their 401k catch-up contributions, possibly as soon as next year. Employees with wages over \$145,000 will now be required to make catch-up contributions to *Roth 401ks* rather than the more typical traditional 401k. Of note, no changes will be made for catch-up contributions to individual retirement accounts (IRAs).

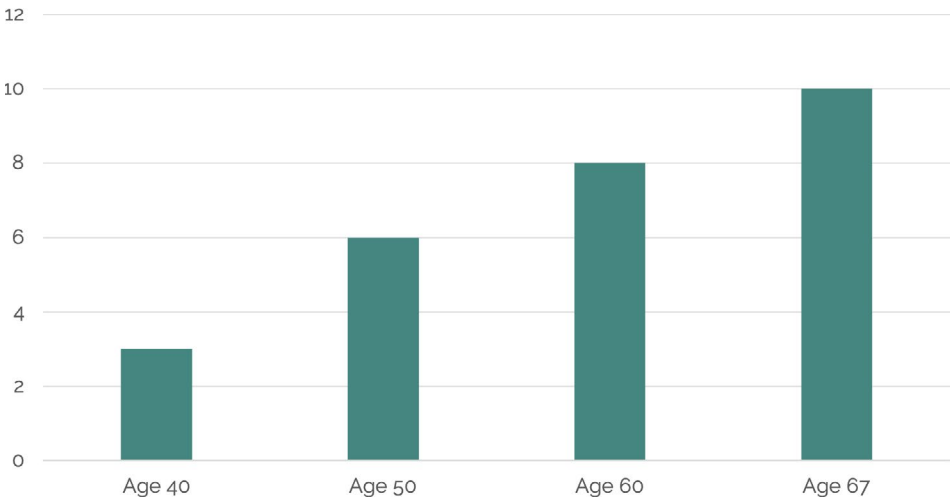
The Background

401k plans are the most popular form of saving for retirement. They come in two flavors - Traditional and Roth. In both cases, retirement savings can *grow* tax free. Traditional 401k contributions are made with pre-tax dollars, which helps reduce your current tax bill, but withdrawals are taxed as ordinary income. In contrast, Roth contributions are made with after-tax dollars, but qualified withdrawals are not taxed at all. Although savers may be familiar with Roth IRAs, many are not aware of Roth 401k plans, which have grown steadily in availability over the last 10 years. To learn more about Traditional versus Roth retirement savings strategies, check out our blog [‘To Roth or Not’](#).

Catch Up Contributions Can Goose Retirement Savings

The financial demands of buying a home, funding kids' education, or helping to care for elderly parents often compete with saving for retirement. See chart below for typical savings goals.

Target Savings at Various Ages as a Multiple of Your Salary



To help workers who have fallen behind in their retirement savings, the U.S. government allows additional 401k contributions starting at age 50. In 2023, a 50-year old can make \$22,500 in regular contributions PLUS an extra \$7,500 in **catch-up contributions** for a total of \$30,000.

Often, older workers are in higher income brackets, and they opt to make pre-tax contributions to their 401k in order to cut their current tax bill. This strategy particularly makes sense for people expecting to be in a substantially lower tax bracket in retirement.

What Just Changed?

New legislation will restrict the number of people who can make **pre-tax** catch-up contributions to their employer retirement plans. Employees whose wages (from their 401k plan sponsor) exceed \$145,000 in the prior year will now have to make **Roth** catch-up contributions - which requires them to pay taxes on the contribution amount.

Silver Lining for Roth Catch-up Contributions

Making a pre-tax contribution may feel good now, but it can lead to unexpected financial burdens in the future. Savers may underestimate the potential growth of their 401k investments, or they may not anticipate the tax consequences of losing a spouse. These factors could result in individuals ending up in the same or higher tax bracket in retirement - when they will be required to take money out of their traditional retirement accounts. The age for these required minimum distributions is now 73, but many retirees start withdrawals earlier.

We believe it would be prudent to keep retirement savings in several different tax buckets – traditional retirement accounts, Roth retirement accounts and taxable accounts. This diversification allows for tax optimization when withdrawing funds. With Roth accounts, workers can build a pot of tax-free money to spend in years when higher taxable withdrawals could push them into a higher tax bracket and/or force them to pay higher Medicare premiums.

Roth retirement savings offer big advantages to non-spouse heirs. Heirs of *traditional* inherited retirement accounts are required to drain the account within ten years. They must make annual withdrawals along the way, a process which can push them into higher marginal tax rates. Alternatively, when inheriting a Roth, the same ten-year withdrawal period applies, but heirs pay no taxes on qualified distributions.

What to Expect

Not all employers offer a **Roth 401k** option, which throws a wrinkle into the government's plan. While the legislation is supposed to take effect January 1, 2024, companies are requesting a two-year delay. Many won't be able to change their systems in time to meet the deadline, which means they can only comply with the legislation by eliminating catch-up contributions entirely – hardly achieving the original objective of helping older retirement savers. While we do expect this legislation to be enacted, systems issues and other glitches mean the deadline is likely to be extended.

You don't have to wait for the law to change. High income earners should think about their personal circumstances and consider making regular or catch-up contributions to Roth 401ks now.

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ADDENDUM

After this was published and as we expected... the IRS gave high earners 50 and up a two year reprieve on the Roth 401k catch-up contributions late Friday, August 25th. We continue to recommend that it would be prudent for high income earners not to wait for the law to change. If your company offers a Roth 401k, it may make sense to consider making regular or catch-up contributions to Roth 401ks now.

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