

CPA Advantage 2 | The Wealth Accumulation Phase | Transcript

Andy Bertke & Ryan Lauer

Ryan Lauer:

The first phase in your financial journey is the accumulation phase. It's often when you're just out of college, you're starting your working career and trying to build your assets up. And it can be a fun time in life. It's the first time maybe you have disposable income, but there's many different buckets that are out there for different financial goals that you have throughout life. The first ones I want to talk about are retirement buckets, a 401(k) and an IRA or an individual retirement account. Andy, can you explain what the difference between those two are?

Andy Bertke:

Sure. A 401(k) is generally offered by your employer and it's something that you can participate in where you can contribute either pre-tax or after tax wages to it. An IRA is set up by the individual person, you yourself as an individual, not as an employee of a company. And in that case, you contribute your own dollars into that IRA.

Ryan Lauer:

Exactly. Now, one big differentiator perhaps for a 401(k) is what can be referred to as a 401(k) match. Andy, can you explain what you see there usually?

Andy Bertke:

Sure. A 401(k) match is a wonderful thing. That means your employer's putting money in for you.

Ryan Lauer:

Free money, right?

Andy Bertke:

Nothing's free. But your employer is going to contribute anywhere up to three to 5% of what you contribute of your salary, so anytime you hear match and that your employer has a match, you definitely want to take a very hard look at participating in that plan.

Ryan Lauer:

And what's the beautiful thing about the 401(k) is you're able to take some of your wages and directly put it into that investment account. You don't have to be the one that actually has to go in and push the buttons to make it happen. And that's a huge advantage over different types of retirement accounts that are out there. When it comes to your 401(k) you're usually making three decisions when signing up

and investing. The first is, what percentage of your salary do you want to put in? And you talked about the company match. Maybe it's up to at least starting with that point, starting up to that percentage to get that full company match. The second decision you make is whether to do your investments traditional or Roth. Andy, inside that 401(k), can you explain the difference between the two?

Andy Bertke:

The difference between a Roth and a regular 401(k), two different events happen. One, when you're putting money into your 401(k), if it's a Roth, you're not getting a tax deduction for it upfront, but then again, you're not paying tax when you take that money out. With a regular 401(k), you are getting a deduction when you're putting the money into the 401(k), i.e. deferring that from your paycheck or taking that out of your paycheck, but then you're paying tax when you take it out.

Ryan Lauer:

And it's a pretty big decision for folks to decide whether they want to go in traditional or Roth into their 401(k). Andy, when it comes to making that decision traditional versus Roth, who are the folks that you think it makes sense for to choose that Roth option or is it not always obvious?

Andy Bertke:

It's not always obvious, Ryan, because with the Roth you're not getting a tax deduction upfront, but you're not paying tax on that money when you take it out. With the regular 401(k) you're getting a tax deduction today, but you're going to pay tax on it tomorrow, so the reason it's not clear is because when we know the tax rates today, we don't know them in the future and that's the big part of the calculation.

Ryan Lauer:

At the end of the day if we had the crystal ball to see what tax rates would be in the future, we could give the right answer and say, "Hey, if the tax rates are going to be lower later, it probably makes sense to defer." But if not, maybe it makes sense to take it now if your tax rate's going to be higher in retirement.

Andy Bertke:

Absolutely. We have no idea what the tax law is going to be five years from now.

Ryan Lauer:

And so to put a little math to this, if somebody were to put \$100 into their 401(k) each pay period and they use the traditional option and it grows and it grows and it grows and it's \$1,000 when they go to retire, when they take those funds out, they're taxed on the full \$1,000. If they choose to use the Roth option, they pay tax on those dollars now, that \$100. And if it grows and it grows and it grows and it's \$1,000 when they go to retire, if they're of retirement age, when they take those funds out, no tax on those dollars there, so it's choosing to say, "Hey, do you want to pay that tax now or pay that tax later?"

Now, for high income earners, they may want to contribute to a Roth IRA, but their income is probably above the limitation that allows you to contribute directly, so you can do what's called a backdoor Roth

contribution and that's doing a non-deductible, so non-deductible for taxes contribution into a traditional IRA and then immediately converting it to Roth. Now, it's a fantastic option for these folks to get additional dollars into their retirement accounts. However, you have to be careful and have a clean fact pattern. Can you tell us a little about that?

Andy Bertke:

Yes, Ryan. There is a very bad tax trap there. If the individual already has an IRA and they take advantage of this backdoor Roth conversion, it can be taxable to them and the majority of it may be taxable to them if they have this other IRA out there.