

Unlock Tax-Free Retirement: Which Retirement Account is Right for You?

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This guide breaks down the tax implications, contribution limits and long-term benefits of different retirement accounts to help you choose the best retirement savings strategy.

By Kaleb Paddock

Inevitably, one of the topics that is brought up during a conversation with any financial planner or accountant is how to save money on taxes. For many individuals, this is the chief problem they expect their financial professional to help them solve: How do I reduce my tax burden? Of course, if you have a significant tax problem you also have a situation that many would envy: A healthy six or seven-digit income (just trying to look on the bright side here).

The financial profession, from advisers to accountants to money coaches, has largely trained clients and the general public to seek out the maximum tax savings possible in any given year. Nothing wrong with that. You very likely may have searched for or been offered investment opportunities that tout tax shelter, tax deduction or tax savings as a key component of the investment's strategy.

One of the most common and straightforward ways to achieve a tax deduction against your current year income is by making contributions to a tax-deductible retirement account, either through an IRA or pre-tax 401(k) contribution. You may even be making contributions to one of these types of accounts currently.

While it's true that these accounts offer current-year tax deductions, they are not really saving you money on your tax bill. So, have you been misled? As with much of life, it depends on your perspective. It's true, you do reduce your tax bill in the short term. But your contributions are not safely protected from taxes forever. Your pre-tax contributions

are merely deferring your taxes owed on that income to a future date. This is a key distinction.

What do I mean by future date? Well, at a minimum, the IRS requires you to begin withdrawing from pre-tax retirement accounts when you've reached age 73, whether you would like to start withdrawing or not. You don't have a choice. Because of these required minimum distributions, or RMDs, you will ultimately pay taxes. Simply put, you are making a trade with the IRS: Avoid paying taxes today, but pay taxes later.

In this light, it's clear that you're not really experiencing tax savings so much as you are experiencing delayed taxation. It's also worth pointing out that if your account value increases through investment growth (which we hope it does), you will be taxed on your original contributions, plus all the investment growth that has accumulated.

At this point, the question that must be asked is: **Is making a tax-deductible contribution always the best decision when making retirement account contributions?**

As you might expect, it depends. It depends on federal and state tax rates during your retirement years compared to current rates. This comparison matters because you are making a trade to pay taxes in the future (at an undisclosed rate) instead of today. We can't know whether tax rates will be higher or lower multiple decades into the future. It also depends on your retirement lifestyle and burn rate. Do you currently earn \$250,000 per year but your burn rate is \$60,000 per year? \$150,000 per year? It matters. The key is understanding the trade-offs and what variables are in or out of your control. You need to be equipped to make an educated decision and minimize future regret. Clearly, there is more to consider than the immediate gratification of current-year tax savings.

Let's use an example of an individual who saved for retirement using only pre-tax retirement accounts, not unlike thousands of Americans. In this scenario, nearly every dollar this person uses to fund their retirement lifestyle will be taxed at ordinary income tax rates. IRA withdrawals? Taxable income. 401(k) withdrawals? Taxable income. Social Security checks? Taxable income (up to 85% of the total benefit). And of course, if you need or want a little extra income and pick up a part-time job during retirement, that, too, is taxable income. Consider the following: An \$80,000 annual retirement lifestyle is, in actuality, a \$100,000 annual withdrawal rate when you include taxes owed, using a combined (federal and state) tax rate of 20%.

Is there an alternative? Some way to voluntarily pay taxes now with your retirement

account contributions, rather than deferring them to the future? Indeed, an alternative is available. The two retirement accounts you can use to effectively accomplish this goal are the Roth IRA and the Roth 401(k) account. Both accounts allow you to contribute on an after-tax basis, rather than pre-tax, i.e. you do not receive a tax deduction when you contribute to Roth accounts. In both Roth IRAs and Roth 401(k)s, any growth or earnings, along with the original contributions, can be withdrawn tax-free once you reach age 59½.

The key differences between Roth IRAs and Roth 401(k)s are as follows:

- **The Roth 401(k) is only available through employer-sponsored retirement plans.** If you are self-employed, you can establish a “Solo 401(k)” or simply contribute to a Roth IRA.

- **The Roth 401(k) allows you to contribute \$23,500 per year, or \$31,000 if you are over age 50 or older.** In the Roth IRA, you can contribute \$7,000 per year, or \$8,000 per year if you are age 50 or older (all 2025 IRS contribution limits).

- **There is no income limit for individuals making Roth 401(k) contributions.** You can earn any amount and be eligible to make Roth 401(k) contributions. Not so with a Roth IRA. If you earn too much, you are phased-out, and ineligible to make Roth IRA contributions.

Why would you do this? Why would you forego conventional wisdom and the pre-tax, immediate gratification tax savings route? One great reason is to tax diversify your nest egg. You and I have no idea what tax rates will be or which tax brackets will apply to your situation in 15, 20, or 30+ years from now. There is no possible way to know what IRS tax rates will be or what kind of financial situation you will experience that far into the future.

However, prudent planning would suggest that you prepare yourself to have options when withdrawing from your retirement accounts. The Roth IRA and Roth 401(k) accounts allow you to make tax optimal decisions in retirement rather than just pray and hope that IRS tax rates go down and your personal financial situation puts you in a lower tax bracket than today, decades from now.

If you are currently used to getting a tax deduction for your retirement contributions, changing to Roth will feel like a pay cut (since you are now paying taxes on your contributions). One option to help begin tax diversifying your retirement could be to take your current contribution, say 10%, and split it 5% pre-tax contribution and 5% Roth contribution. Remember, any matching contributions that your employer may contribute to your account are pre-tax in nature and you will end up paying taxes on those monies one day.

Since with Roth contributions you are both paying taxes and saving in a retirement

investment vehicle, you are saving more than you could if you maximized the IRS limits of pre-tax accounts.

Here's a great example of how switching to Roth contributions helps you save more toward retirement:

Traditional pre-tax IRA maximum contribution, for 2025: \$7,000 (tax-deductible).

Tax reduction on your current year taxes: \$1,400 (\$7,000 times 20% assumed combined tax rate).

End result: At the 20% tax rate, your portion of the account is \$5,600 and the IRS portion of the account is \$1,400. From this point forward, it's a joint venture. You and the IRS have a stake in the account.

Yes, I am assuming that, in all likelihood, you spend your tax savings on discretionary expenses rather than re-invest it in other investments. Kudos to you if you invest your tax savings or tax refund checks. I want to meet you. Seriously. But let's compare this to the Roth option.

Roth IRA maximum contribution, for 2025: \$7,000 (after-tax).

Tax reduction on your current year taxes: \$0.

End result: You are actually contributing \$8,750 of gross income in this scenario, which, after paying taxes (again assuming 20% tax rate) nets you \$7,000 for the Roth contribution. And the IRS has no future stake in the \$7,000 or the account growth. While the traditional IRA offers you a \$7,000 limit, the Roth IRA essentially offers an \$8,750 limit (in this example at least) since the taxes are paid "off the top."

Unquestionably, making Roth contributions doesn't make financial sense for every person. If your current income has you comfortably and significantly placed in the top tax brackets both on federal and state levels, you will be hard-pressed to make the Roth contributions a sensible strategy as part of your financial plan. However, with the tax rate brackets in effect for 2025 as a result of the Tax Cuts and Jobs Act, the Roth option deserves serious consideration and discussion in every financial planning conversation.

As always, consult with your tax adviser or financial planner before you make any changes to your accounts. Realize that switching to a Roth won't make your advisers look good in the short-term since you won't be saving on taxes this year. But Roth contributions will help you tax-diversify your retirement accounts, save even more towards retirement, and provide you tax-free withdrawal options in retirement.

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Kaleb Paddock, CFP®, is the founder of [Ten Talents Financial Planning](#). He helps couples live life better through optimizing and coordinating their finances, while guiding them to create a shared, united vision for their future. He provides done-for-you investing, tax planning and retirement planning. He's blessed to live in colorful Colorado, with his wife and their four sons.