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RETHINKING THE ROTH IRA

THE BENEFITS OF MAKING ROTH CONTRIBUTIONS

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If you are currently working to save for retirement, you may be wondering what types of accounts are most advantageous. While it's wise to invest in several types of accounts, including employer-sponsored retirement plans, traditional IRAs, and after-tax accounts, I believe the most advantageous is the Roth IRA because of the tax-free growth it provides.[1]

Let me repeat that – TAX-FREE growth! Not only does this tax-free status apply when you retire, it also applies for any children or grandchildren who inherit your account. This is a huge advantage when building generational/legacy wealth, but it also allows you to provide for yourself in retirement. Just like airlines instruct you to put on your own oxygen mask before helping others, a Roth IRA can help ensure your financial independence so you don't need to rely on your kids for support in retirement.

For perspective, the assumed benefit of a traditional IRA or 401(k) is that they allow you to defer taxes while you are working and in a higher tax bracket, then pay taxes on your withdrawals when you are retired and in a lower tax bracket. You are essentially choosing to pay taxes at a later date. For example, you make contributions to your traditional IRA when you are in the 32 percent tax bracket, then pay 12 percent on withdrawals once you are retired. Hopefully, this is how it works out. However, I work with many retired clients who are now exposed to higher tax brackets than they ever imagined. This is especially true for clients who collect multiple sources of income from Social Security, pensions, required minimum distributions and rental properties.

While it's easy to see the benefit of the 100 percent tax-free growth of a Roth IRA, these accounts also offer the following benefits:

- **No required minimum distributions** – Unlike with traditional IRAs and 401(k)s, the IRS does not require withdrawals from a Roth account at a specific age (currently age 72)[2]. Why not? Simply put, the IRS is not motivated to require withdrawals because you have already paid taxes on the contributions (i.e., there's nothing in it for them).
- **Control over your taxes** – Having access to tax-free funds during retirement provides you with flexibility to withdraw funds without falling into a higher tax bracket.

You may be thinking that Roth contributions sound great, but you make too much money[2] to contribute. Following are a few strategies that may allow you to take advantage of the tax-free growth within a Roth account.

Roth 401(k) contributions (part one)

Many employers now offer the option to make Roth contributions to a 401(k) plan. For example, in 2020 and 2021, plan participants under age 50 can make up to $19,500 in Roth 401(k) contributions, and participants age 50 and older can contribute up to $26,000. There are no income level phaseouts for these contributions.

In addition, 401(k) contributions have no impact on the amount you can contribute to an IRA (traditional or Roth). While you will be giving up any tax-deferral benefits today, Roth 401(k) contributions will grow 100 percent tax-free.

It is important to note that any company matching contributions will be made with pre-tax dollars. Once you leave your employer, your pre-tax and after-tax contributions will be rolled over separately into a traditional IRA and a Roth IRA, respectively.

Roth 401(k) contributions (part two)

If you are fortunate enough to have a Roth 401(k) option and wish to save even more on an after-tax basis, it may be possible to contribute after-tax dollars to a sub-account within your 401(k). Based on your plan's rules, you may be eligible to make an additional annual contribution to this sub-account, up to an annual maximum contribution of $57,000 (in 2020). For example:

- You contribute $26,000 to your Roth 401(k) through payroll deferrals.
- Your employer matches 75 percent of your contributions, or $19,500, in the pre-tax part of your 401(k).
- You can contribute (post-tax) an additional $11,500 into the sub-account.

Back-door Roth conversions

While it may make sense to complete a traditional (read: taxable) Roth conversion, a back-door Roth conversion is a tax-free option. There are some limitations that accompany this strategy, so it's important to have a complete understanding of your specific situation before attempting a back-door conversion. That said, following is an example of what this type of conversion may look like:

- You make a non-deductible contribution to your IRA up to the maximum of $6,000 (for those under age 50) or $7,000 (for those age 50 and older). You do not receive any tax benefit now.

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- You immediately roll over this non-deductible IRA contribution to your Roth IRA. Again, this is not a traditional (taxable) conversion, as you elected to not deduct your IRA contribution.

It's important to note that this strategy may not work for you if you have an existing IRA, SEP IRA, or simple IRA, as the IRS does not allow a fully tax-free back-door Roth conversion if you still have a balance in any of these three accounts. While you may wish to consider a traditional, taxable Roth conversion to zero out these accounts prior to the end of the year and get ready for a back-door conversion, it's wise to consult with a financial advisor prior to doing so in order to understand any potential tax impact.

I hope the above strategies highlight a few ways you may be able to take advantage of tax-free retirement growth and earnings that exceed certain IRS limits. While it's always possible the IRS can decide to change its rules and begin taxing Roth IRAs, I believe the probability of this happening is low for several reasons:

- To do so would be a 180-degree reversal from the Taxpayer Relief Act of 1997, during which the Roth IRA was introduced. This would be met with a lot of resistance[3].
- Roth contributions are already limited and are essentially designed for those in lower tax brackets. In other words, they do not impact the ultra-high-net-worth individuals who are most frequently targeted when major tax policy changes are considered.

Regardless of how much you plan, there will always be unknown variables as you execute on financial and investment planning strategies. When you consider contributing to a Roth IRA or 401(k), you are essentially deciding to pay taxes today in exchange for no taxes later. Although it's impossible to know for sure what tax bracket you will fall into at retirement, there is a lot to be said for controlling your own tax destiny for at least some of your savings.

Personally, I am betting heavily on the benefits of eliminating this tax variable as I plan for my retirement. I will also be encouraging my kids to begin leveraging Roth contributions as early as possible.

Are you considering contributing to a Roth IRA? Creative Planning can help. Our advisors are experienced in helping clients plan for retirement and will work with you to ensure any decisions make sense in light of your overall financial portfolio. Contact us to get started.

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[1] It's important to note that Roth IRAs impose a waiting period on certain withdrawals. Known as the five-year rule, this waiting period applies if you withdraw account earnings, if you convert a traditional IRA to a Roth IRA or if a beneficiary inherits a Roth IRA. Failure to comply with the five-year rule may result in income taxes on earnings and a 10 percent early withdrawal penalty.

[2] In 2020, the ability to make Roth IRA via traditional means is entirely phased out once your modified adjusted gross income exceeds $139,000 for single filers, and $206,000 for married-joint filers. This is really more applicable to where I put #2 "too much money"

[3] Especially from yours truly!

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