Fairhaven Whitepaper

Patient, enduring growth. | October 2016

by **Marc Horner**
President
mhorner@fairhavenw.com

Strategies to Supercharge Your Roth IRA Bucket

Look around the next time you are in the checkout line at the grocery store. Nearly everyone you see has two income tax buckets on their personal balance sheets – currently income taxable and eventually income taxable. Currently taxable assets include individual, joint and trust accounts. Eventually taxable assets include regular IRAs, 401ks, deferred compensation plans and annuities. The power of the Roth IRA enables you to create a third income tax bucket – one that is protected from future income taxes. This protection continues for both you and your heirs. The ability to protect assets from income taxes for two generations is incredibly powerful. Because of this, it is very important to be aware of Roth "maximization" strategies.

Strategy #1 takes advantage of a law, that since 2010, has changed the ways money can get into a Roth IRA. That law drew a significant distinction between Roth IRA "contributions" and "conversions". Roth IRA contributions continue to be restricted by certain income limits, meaning the ability to contribute to a Roth is eventually phased out according to a person's annual income. However, there are no income limitations for IRA money being converted into a Roth IRA. Regardless of your income, since 2010 you have been allowed to make an after-tax contribution to a regular IRA, and then convert that contribution to a Roth IRA. Currently, both regular and Roth IRA annual contribution limits are $5,500 (or $6,500 for those age 50 and over). Five to six thousand dollars per year is a good start but how can we do more? The "pro rata" rule is lurking out there so be sure to talk to your accountant about possible tax consequences if you have other IRA assets.

Strategy #2 takes advantage of the design in your company 401(k) plan. When one is asked how much money can be saved in a 401(k) plan in 2016, the popular answer is $18,000 (or $24,000 for those age 50 and over). While that figure is accurate, the answer is not complete. Section 415 of the Internal Revenue Service allows for as much as $53,000 to be saved in a 401(k) plan (or $59,000 for those over the age of 50). The $18,000 limit with which so many people are familiar is specific to elective deferrals, or the 401(k) contributions a person elects to contribute from their own compensation. The difference between elective deferrals and 415 limits can include company contributions (e.g., profit sharing and/or matching contributions) and additional employee "after-tax" contributions. On top of that, an employee has the ability to maximize this total amount regardless of their income. This is where the Roth maximization opportunity lies.

Provided your company's 401k plan allows for both (1) after-tax contributions and (2) in-service distributions of those after-tax contributions, you can turn your 401k plan into a Roth supercharger!

Let's walk through an example to better understand how this works:

Susan is age 46 and maxing out her elective deferrals to her company 401k plan: $18,000

The company matches Susan's deferrals at 50%: $9,000

Amount remaining under the 415 Limit for Susan to contribute "after-tax":. $26,000

Provided the 401k plan design at Susan's employer also allows for "in-service distributions" of her after-tax contributions, Susan can rollover to her Roth IRA the $26,000 in after-tax contributions. Combined with Strategy #1, Susan would be funding her Roth IRA with $31,500 – more than 5X than using Strategy #1 alone!

Fairhaven
wealth management

Note: to the 401k plan sponsor, Strategy #2 presents an opportunity to provide their employees a “free” additional benefit - appropriate plan design and a knowledgeable financial advisor to deliver the education are all that is required.

A popular phrase in the investing world is “It’s not what you make that matters, it’s what you keep”. The government generates revenue one way and this is through taxation. Taxes are frequently the largest drag on the performance of any portfolio. These Roth IRA supercharging strategies are excellent ways to build the Roth IRA bucket on your balance sheet and help reduce that drag.

About Fairhaven

Fairhaven Wealth Management is an independent, privately owned investment and wealth management firm serving select families and small to mid-sized businesses. At Fairhaven, our commitment is simple – we exist to serve our clients…period. Our culture of service and accountability combined with prudent risk management and tax-efficiency are the cornerstones of our client commitment.
www.fairhavenwealth.com

For more information, please contact:

Marc Horner, CFP®, CIMA®
Wealth Advisor
President
mhorner@fairhavenw.com
630.990.9000

Fairhaven
wealth management