MAKING THE MOST OF YOUR 401(K): ROTH STRATEGIES

RHAME & GORRELL
WEALTH MANAGEMENT

People contact us regularly to inquire about the most tax-efficient way to save money for their retirement. Most are frustrated by the low annual contribution limits for tax-advantaged vehicles like their Traditional or Roth IRA or their 401(k). At $6,000/year in an IRA and $20,500/year in a 401(k), many individuals wish there was a place to put their excess income above these limits, but just don't know where. Enter the Mega-Roth: a unique tax strategy with no upper limit on income for eligibility.

<table>
<tr><th colspan="4">Employer Plan</th></tr>
<tr><th>CONTRIBUTION TYPE</th><th>PRE - TAX</th><th>ROTH 401 (K)</th><th>AFTER - TAX</th></tr>
<tr><td>Tax Treatment of Contribution</td><td>Taxes Paid Upon Distribution</td><td>Taxes Paid Up Front</td><td>Taxes Paid Up Front</td></tr>
<tr><td>Tax Treatment of Contribution</td><td>Taxes Paid Upon Distribution</td><td>Not Taxed if Qualified Distribution</td><td>Taxes on Growth Paid Upon Distribution</td></tr>
<tr><td rowspan="2">Contribution Limits (2022)</td><td colspan="2">$20,500 between Pre-Tax and Roth, $27,000 if >50 years</td><td>Subject to Annual Limits</td></tr>
<tr><td colspan="3">All contributions (employee's and XOM's) cannot exceed lesser of $61,000 ($67,500 if >50) or 27% of income</td></tr>
<tr><td>Employer Match</td><td>Employer defined % on up to $305k of income</td><td>All Match is Pre-Tax</td><td>All Match is Pre-Tax</td></tr>
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MEGA BACKDOOR ROTH STRATEGY

Most employers allow plan participants to contribute to their 401(k) through pre-tax and Roth contributions. Employees can generally contribute up to $20,500 a year ($27,000 if age 50 or older) from their paycheck. What people are less aware of is that roughly half of all active 401(k) plans allow for additional after-tax contributions beyond this limit. These plans permit you to contribute additional funds after-tax to the plan each year which can in some cases be converted tax-free to Roth at your convenience.

HERE'S HOW IT WORKS:

- Max-out your Pre-Tax or Roth contributions to the 401(k) ($20,500 for 2022)
- Receive 7% matching contribution
- Contribute After-Tax funds up to the IRS Limit ($61,000 in 2022)
- Convert After-Tax Funds to Roth Account

<u>Consider this example:</u>

An employee (let's call him Bob) has a salary of $250,000. He contributes the max of $20,500 to his 401(k) for 2022, $40,500 below the IRS limit of $61,000. Let's assume Bob then contributes $30,000 each year to the After-Tax account in the Savings Plan for 5 years – a total amount of $150,000. This money has grown over the 5-year period to a value of $250,000. Therefore, for conversion purposes, $150,000 is Bob's cost basis and $100,000 is growth.

TAX IMPLICATIONS

Needless to say, any time a citizen receives a tax-advantage, Uncle Sam isn't far away. He wants to get his share of this windfall! The IRS has instituted a Pro-Rata rule that mirrors the one associated with a traditional backdoor Roth IRA.

If Bob were to simply withdraw the $250k After-Tax amount, he will pay ordinary income tax on the portion of the withdrawal that represents the growth ($100k). The same goes for a conversion from the After-Tax account to the Roth Account. 40% ($100k/$250k) of any conversion will be taxable, because that is the proportion of the value that is represented as growth.

Conversely, if Bob had completed annual conversions, this strategy becomes quite a bit more attractive. If Bob were to make ongoing conversions before any growth occurred, these After-Tax assets are placed into the Roth Account and compound tax-free permanently. As the chart above shows, qualified Roth withdrawals are always tax-free. In essence, Bob can use this strategy to permanently eliminate the tax on growth of After-Tax assets!

THE CATCH

The catch, if there is one, is this: many people already have a current after-tax balance in their 401(k). If you inadvertently contribute too much to the Pre-Tax or Roth accounts, the excess automatically rolls over to the After-Tax balance. While this does not prohibit you from taking advantage of this strategy, the After-Tax balance can grow over time and make conversion strategies more complicated.

Before making conversion decisions, it's important to identify what your After-Tax account balance is and compare that to your contribution basis (typically denoted as the sum of your Pre-1987 and Post-1986 contributions). This will give you an idea of how the Pro-Rata rule comes into play for the taxation of conversions.

NEED SOME HELP?

If you'd like some help from a CERTIFIED FINANCIAL PLANNER (CFP®) advisor regarding this strategy and how it applies to you, the Rhame & Gorrell Wealth Management team is here to help.

Our experienced Wealth Managers can help you review your financial and tax situation inside the 401(k) and come up with a custom tax optimization strategy going forward – all at no cost to you!

Feel free to contact us at (832) 789-1100, service@rgwealth.com or https://rgwealth.com/lets-get-started/ today to schedule your complimentary strategy session.