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Roth IRAs: A Pragmatic Approach to Retirement Planning

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When determining appropriate retirement savings strategies, the ever-changing retirement plan landscape can be difficult to navigate. At GHP Investment Advisors, our team continuously monitors opportunities and develops strategies to maximize our client's retirement savings. In this article, we will focus on a specific type of retirement account called a **Roth Individual Retirement Account (IRA)** and different ways of utilizing the account's unique features.

Roth IRAs are seemingly magical retirement savings vehicles that provide tax-free growth on investments and distributions. When you hear about Roth IRAs, you may instinctively think they only apply to younger people. However, there are strategies that many mid/late-career individuals or retirees can deploy. Our clients use the Roth IRA vehicle as an opportunity to build retirement savings in a tax-advantaged way. As with all financial opportunities, it is important to understand a variety of factors before determining if a Roth IRA is a good fit. For example, a household's tax bracket, total income, and age are addressed when analyzing. Competing priorities related to legacy goals and cash flow needs also need to be factored in as these strategies are not one-size fits all.

Roth IRA Basics and Eligibility

While a Roth IRA can be an ideal way to save for retirement, not everyone is eligible to contribute. For Roth IRA accounts, contributions are made using after-tax dollars. Due to the strict income limits for eligibility, most investors are in lower tax brackets when they make contributions. The contributions then grow tax-free until retirement and are tax-free upon distribution. Magic!

To contribute to a Roth IRA investment vehicle, both income limits and contribution maximums are legislated rules. If married and filing jointly, your joint Modified Adjusted Gross Income (MAGI) in 2024 must be less than $230,000. For single filers, the income limit is $146,000. The maximum contribution amount for 2024 is $7,000. Investors over age 50, are eligible to make a catch-up contribution of $1,000 for a total of $8,000.

401(k) vs Roth 401(k)

Employer-sponsored retirement plans called 401(k)s are common and popular savings options for employees. Some, but not all, employers match an employee's contributions dollar for dollar up to a certain amount. Additionally, employer-sponsored retirement plans may offer both 401(k) and Roth 401(k) options[1].

Traditional 401(k) contributions are made using pre-tax dollars and distributions in retirement are taxed at ordinary income rates. Pre-tax contributions to a 401(k) can be advantageous for employees in high tax brackets as contributions reduce taxable income. Alternatively, Roth 401(k) plans are made with after-tax dollars and distributions in retirement are typically tax free. Generally, for high earners, the tax deferral savings to a 401(k) will outweigh the after-tax savings to a Roth 401(k). When deciding whether a 401(k), Roth 401(k) or traditional Roth IRA is best, we review several factors including current and estimated tax rates and cash flow needs to determine an appropriate vehicle.

[1] Single employee 401(k) plans are also eligible for Roth 401(k) plans.

Roth Conversions

Another frequently used strategy is a Roth conversion. Put simply, a Roth conversion converts after-tax dollars (from a 401(k) or IRA) to a Roth IRA. Generally, the conversion amount is taxable at ordinary income rates in the year of distribution. After conversion, the amount contributed will grow tax free. Roth conversions are most appropriate when a client has lower total income because of a change in household circumstances or retirement. We find there is an ideal window between retirement and Required Minimum Distribution (RMD) age to complete a conversion due to being in a lower income tax bracket. Our team regularly conducts analysis, in concert with a tax professional, to determine if a Roth conversion is a beneficial strategy. However, if a client will be in a low tax bracket throughout their retirement, an argument can be made against a Roth conversion as the investor is essentially only prepaying taxes in the year of the conversion.

Back-Door Roth Contributions

An IRA tax loophole has created an opportunity for some investors to contribute to a Roth IRA for those who do not qualify based on income limits. As a reminder, only investors under a certain MAGI level are eligible for a Roth IRA contribution. The Back-Door Roth contribution combines elements of a Roth IRA contribution and a Roth conversion. In practice, an investor makes a non-deductible IRA contribution to a traditional IRA and then immediately converts the contribution to a Roth IRA. Your contributions to an IRA account are never taxed when distributed, so, in theory, the immediate conversion of a contribution results in a full Roth contribution tax-free. Like traditional Roth IRA contributions, the maximum contribution amount in 2024 is $7,000/investor and $8,000/investor for those over age 50.

Another key component of this strategy is the need to have a lower balance in your Traditional IRA when making the non-deductible contribution. If you have earnings or deductible IRA contributions (including rollover IRAs from a previous employer sponsored plan) in any IRA account, the conversion could result in unintended taxation and early withdrawal penalties. It is important to discuss the impacts and eligibility with your tax advisor.

Excess 529 Savings and Roth IRA Relief

As part of the **SECURE 2.0 Act**, unused funds within a 529 savings plan are now eligible to be rolled over to Roth IRA accounts for beneficiaries. Beginning in 2024, a beneficiary of a 529 savings plan can roll over a distribution from the 529 savings plan to a Roth IRA if certain criteria are met.

1. The rollover amount cannot exceed the maximum Roth IRA contributions amount.
2. The 529 savings plan must be open for a minimum of 15 years.
3. The lifetime maximum is $35,000 and the limit cannot be used in one year.

This new rule gives some relief to owners of 529 plans whose account balances have exceeded what is needed to cover qualified education expenses. Similar to traditional Roth IRA contributions, the beneficiary receiving the rollover must have earned income up to the contribution limit to make a full contribution. However, the income limits do not apply.

As holistic wealth managers, GHP Investment Advisors team provides retirement planning guidance for our clients which includes Roth IRA savings accounts. Our experienced team maintains awareness of current tax legislation to help navigate and advise on beneficial planning approaches. In combination with your trusted tax professionals, we routinely conduct analysis to determine if a Roth IRA strategy is applicable and advisable. If you have questions regarding how a Roth IRA could assist in your planning and wealth creation, please call our team at (303) 831-5041.

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