

# MEGA BACKDOOR ROTH

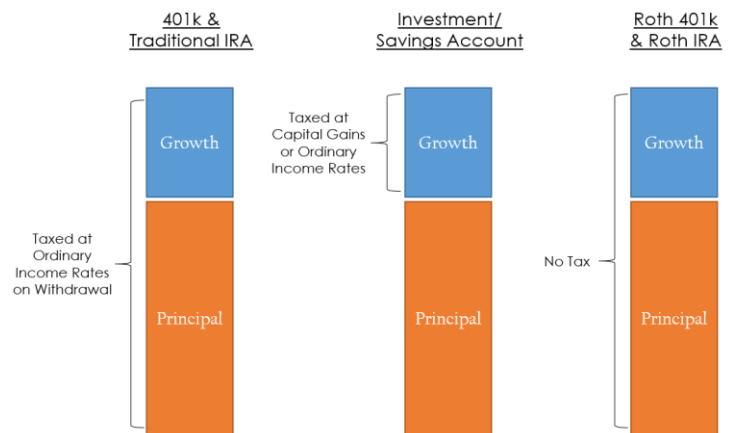
How would you like to have tax-free income in retirement? Is your income too high to contribute directly to a Roth IRA? Ever wonder if there is another way to get savings into tax-free accounts? Based on IRS Notice 2014-54, retirement plan participants may consider the “*Mega Backdoor Roth*” strategy as a means to maximize savings in a tax-free account. This strategy allows high-income earners, typically not eligible, the ability to move money into a Roth IRA account. In addition, it allows individuals to contribute substantially more than the standard Roth IRA contribution limit. The savings and tax-free growth can be substantial, especially for those in high tax brackets and those planning to retire prior to age 59 ½.

## Tax-Deferred vs. Tax-Free

So, you’re already saving to your 401(k), why should you consider saving to a Roth IRA as well? Assets that accumulate in 401(k) accounts or Traditional IRAs grow tax-deferred, however they are subject to ordinary income tax rates upon withdrawal. These rates can be as high as 37% depending on your tax situation. These assets are also subject to Required Minimum Distributions (RMDs) once the account owner reaches the age of 70 ½, and will be required to withdraw a portion of the assets every year whether the funds are needed or not. In contrast, contributions to Roth IRA accounts are made on an after-tax basis and any future growth on the assets remains tax-free. Contributions can be withdrawn at any time without tax or penalty. Upon age 59 ½, or under several qualifying reasons, the growth on these assets can be withdrawn tax-free.

## After-Tax vs. Tax-Free

Some may wonder, why not just save these extra dollars to an after-tax brokerage or savings account? Well, assets that accumulate in these types of accounts are subject to capital gains tax rates. Dividends received, interest received, and any time investments are sold, it triggers a capital gains tax event even if the funds are reinvested into the same or another investment. Capital gains tax rates can be as high as ordinary income rates, if assets are held less than one year, or 20%, if held for over one year. Assets held in a Roth IRA account are exempt from taxes on dividends, interest, and investment gains.



**The Strategy**

The IRS has clarified that when transferring money from a 401(k), individuals may divert the pre-tax portion and all investment growth to a Traditional IRA and the after-tax portion to a Roth IRA, without incurring a taxable event. For individuals, whose employer allows in-service distributions, this creates a unique opportunity to transfer savings to an account outside of their 401(k) plan to allow for greater flexibility and investment options. This presents an opportunity to transfer after-tax money into a Roth IRA account, and benefit from potential tax-free growth.

**How It Works?**

For 2019, the total 401(k) contribution limit is \$56,000 (if under age 50) and \$62,000 (if over age 50). The limit includes before-tax, after-tax, and employer match. This means after maximizing your before-tax contributions and receiving your company match, you can contribute additional funds on an after-tax basis. These contributions could be as high as \$37,000 per year. So, how does this work exactly? If your 401(k) plan allows in-service distributions, begin making after-tax contributions. Request on a monthly, quarterly, or annual basis that the after-tax balance be transferred via direct rollover to a Roth IRA account. Remember, any growth prior to the rollover must be rolled into a Traditional IRA. Once deposited into the Roth IRA, invest the funds as appropriate and future growth will be tax-free.

**Example – Over Age 50**

Let’s say you are over age 50 and make \$150,000 in salary and bonuses. You are maximizing your before-tax 401(k) contributions at \$25,000 per year. Your employer matches at 5%, which equals \$7,500 per year. This leaves you the ability to contribute an additional \$29,500 on an after-tax basis. At the end of the year, you decide to roll your total after-tax contributions to Roth IRA. Let’s assume the Roth IRA grows by \$5,000 the following year. You will have benefited from tax-free growth, and any growth in subsequent years will also remain tax-free. See Illustration #1.

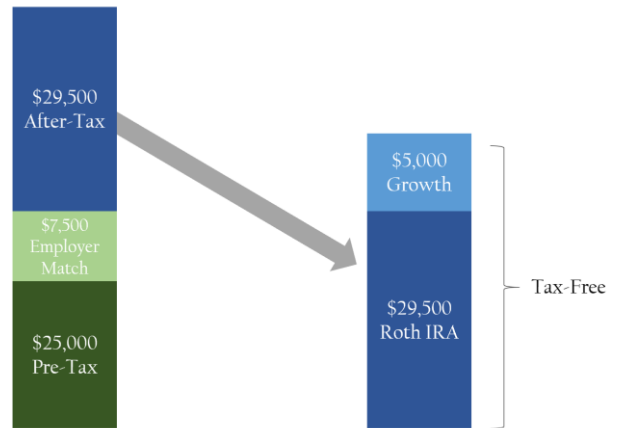
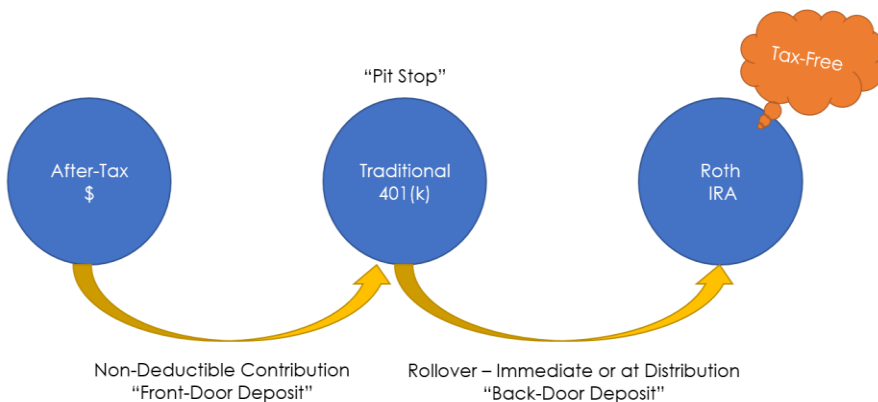


Illustration #1



**Example – Under Age 50**

The same concept applies if you are under age 50. The total contribution limit is lower at \$56,000, however the maximum for before-tax contributions is less at \$19,000. Assuming your employer matches at 5%, this would allow you to contribute another \$29,500 after-tax. See Illustration #2.

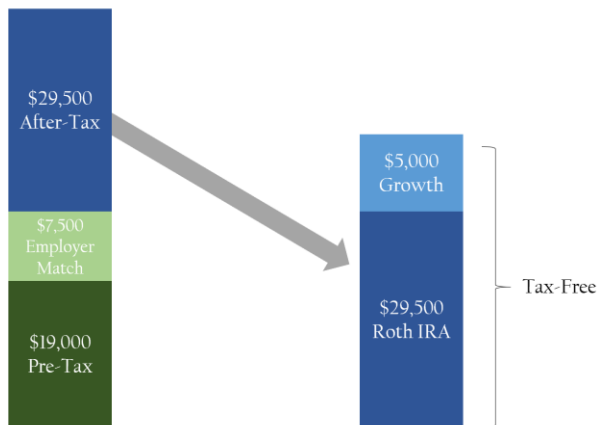


Illustration #2

**Summary**

By taking advantage of the “Mega Backdoor Roth”, you can potentially save a substantial amount to a tax-free account. The strategy is available to individuals at all income levels. The benefits can give you greater flexibility, increase your investment options, and help lower your tax liability in retirement. To confirm eligibility, contact your retirement plan sponsor to verify after-tax in-service distributions are allowed. We recommend working with your advisor to ensure the process is completed correctly without unforeseen tax implications.

**Other Factors to Consider**

At Bogart Wealth, we always recommend a discussion with your advisor before choosing any financial strategy. While this document attempts to provide an accurate general overview of the strategy, there are many factors, both in your own financial situation, as well as in the tax code, stock markets and other variables, that you must consider with your advisor before you can make an informed decision.

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