TRUST
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Roth Rules

How to Make a Roth Work for You

Roth IRAs can be a great vehicle to save for retirement, but what are the benefits and, importantly, what are the rules to make it work? Let's begin with a few basics:

The Roth IRA was introduced in 1997, and some employees have been able to contribute to their employer's Roth 401(k) retirement plan since 2006. The idea behind the Roth is that contributions are deposited on an after-tax basis.

You voluntarily elect to pay taxes today on your contribution amount and your earnings are tax-free, not tax-deferred, as long as you play by the rules of the Roth. This tax-free benefit also transfers to your heirs, making the Roth a very effective vehicle for transferring wealth to the next generation.

As an example, you choose to contribute $10,000 to your 401(k) this year on a Roth basis. You will pay taxes on the $10,000 since you are not receiving a current tax deduction for the contribution. After 30 years of growth, let's say your balance is now $35,000, $10,000 of your original contribution plus $25,000 of earnings. Your entire balance is tax free, even the earnings.

Contrast this with choosing to put the $10,000 in as pre-tax contribution. You receive a current tax deduction in 2016 for the $10,000 contribution and the balance grows to the same $35,000, but now every dollar of the $35,000 you withdraw is taxable to you in retirement.

The Roth Rules

Keep in mind that some of the rules are very different between a Roth IRA and a Designated Roth Account in a 401(k) plan. It is important to know which vehicle you are utilizing in determining the rules.

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One of the most significant differences is your eligibility to contribute to a Roth. A Roth IRA is subject to income limitations, a married couple with adjusted gross income in excess of $194,000 in 2016 is not permitted to contribute to a Roth IRA.

This same income limitation does not apply for the 401(k) plan, so this same couple could contribute Roth funds to a 401(k) plan. You may also contribute far more to a 401(k) plan than a Roth IRA: $18,000 to your 401(k) plan versus $5,500 to a Roth IRA. And if you are age 50+, you may contribute an additional $6,000 to the plan or $1,000 to the Roth IRA as "catch-up contributions".

Required minimum distributions (RMD), the forced withdrawal of a portion of your balance beginning at age 70 ½, is another difference. Roth IRA balances are not subject to required minimum distribution rules, but Roth balances in a 401(k) plan will require distributions. You may rollover your Roth 401(k) plan balance to a Roth IRA in order to avoid a required minimum distribution.

In order to reap the tax-free benefits, any distribution must be considered a qualified distribution. In order for your distribution to be considered a qualified distribution, it must satisfy the five-year holding period and it must be made after you reach age 59 1/2, become disabled, paid to your beneficiary after your death, or meets the first-home exception.

The five-year holding periods work differently between an IRA and a 401(k) plan. For IRAs, even multiple IRAs, you can use the earliest contribution year of any of your Roth IRAs to determine if you have met the five-year holding period for all of your Roth IRAs. For 401(k) plans, on the other hand, each plan has its own start date and the clock start date does not transfer to an IRA. When you are approaching retirement, you should consider the vehicle your Roth is located in. If you have used a Roth IRA, you are ready for retirement.

Not all 401(k) plans offer the ability for Roth contributions. If your plan does not, ask your retirement plan representative to give us a call. We are happy to visit about your individual situation and offer our assistance in navigating the Roth rules.