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Grow Your Retirement Savings Without Growing Your Tax Bill

Each and every year, I run across countless individuals who foolishly pass up the opportunity to shift money from a taxable account to a tax-free account—all without increasing their tax bill. This is generally a big mistake. It may not make or break your retirement, but most long-term financial success comes not as the result of one or two really good big decisions, but rather, by taking small, but consistently positive steps.

Roth individual retirement accounts can be powerful tools. They allow you to put money aside today that can grow tax-free for the remainder of your lifetime, and there are no required minimum distributions, as there are for traditional IRAs. Of course, nothing worth having in life comes without a cost, and the Roth IRA is no exception. In order to get money into the future tax- and RMD-free haven that is the Roth IRA, you have to pay tax on the funds that go into the Roth IRA before they go into the Roth IRA.

Broadly speaking, there are two ways to get money into your Roth IRA: through contributions and conversions. One important distinction between the two is that conversions generally increase your taxable income and therefore your tax bill. Contributions, on the other hand, do not increase your income. Huh?

Let me explain: When you make a Roth IRA conversion, you're generally taking money that was put into an account on a pre-tax basis—meaning funds for which a tax break was already received when you made the contribution—and turning it into after-tax Roth IRA money. In order to do that, you essentially have to reverse your old tax break by adding to your income the pre-tax funds you contributed to your IRA, 401(k) or similar account and paying tax on those funds.

For example, let's say that from 2011 to 2015, you made annual deductible contributions to a traditional IRA of $5,000, for a total of $25,000 of contributions. Over time, the account has grown to $40,000. Now, if you want to convert those funds to Roth IRA savings in 2016, you'll have to add that $40,000 to your income. Thus, if you convert today and your income would otherwise be $100,000, the conversion will result in you owing tax on $140,000 for 2016.

It's often misunderstood, but the same is not true of Roth IRA contributions. When you make a Roth IRA contribution your income is not increased and you do not owe any more tax for a year than if you had not made a Roth IRA contribution. So why the confusion?

In my experience, the confusion typically arises because people are mentally comparing a tax bill after making a deductible traditional IRA contribution with a tax bill after making a Roth IRA contribution. In comparing the two, the latter will leave you with a higher tax bill, but that's an unfair comparison. It's only higher relative to a tax bill that's been reduced because of a deduction, not because something's been done to increase the tax bill, like a Roth IRA conversion does. Saying a Roth IRA contribution increases your tax bill is the equivalent of saying that not giving to charity increases your tax bill. Sure, your tax bill could be lower if you made charitable contributions, but not making them doesn't increase your tax bill. It just doesn't lower it. The Roth IRA contribution works the same way.

Consider the following three scenarios to further illustrate the point:

Scenario 1: You make $100,000 and make a $5,000 deductible contribution to a traditional IRA. You pay tax on $95,000.

Scenario 2: You make $100,000 and make a $5,000 contribution to a Roth IRA. You pay tax on $100,000.

Scenario 3: You make $100,000 and do not contribute to either a traditional IRA or a Roth IRA. You pay tax on $100,000.

All else being equal, scenario 1 will yield the lowest tax bill. Scenarios 2 and 3 will produce identical tax bills.

What's not in the illustration: Scenario 2 offers you a good opportunity to save on future tax bills because contributions to a Roth IRA grow tax-free. Consider this: If you make a $5,000 Roth IRA contribution with funds that were previously in a taxable investment account and that contribution earns 10%, you've essentially shifted $500 ($5,000 x 10% = $500) from a taxable pocket to a tax-free pocket. Do that year over year, and you're talking some serious tax savings!

And if you have $25,000 just sitting in a savings account, it's probably earning almost next to nothing considering today's rates. That may be frustrating, but a further slap in the face is that every dollar of your barely-there interest is taxable. If, on the other hand, you shifted $5,000 of your savings account money into a Roth IRA, it may not earn a higher rate of interest, but at least that interest will generally be tax-free.

So how do you know if contributing to a Roth is the right move for you? Simple. Just ask yourself these two questions:

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Six Potential 401(k) Rollover Pitfalls

You're about to receive a distribution from your 401(k) plan, and you're considering a rollover to a traditional IRA. While these transactions are normally straightforward and trouble free, there are some pitfalls you'll want to avoid.

1. Consider the pros and cons of a rollover.

The first mistake some people make is failing to consider the pros and cons of a rollover to an IRA in the first place. You can leave your money in the 401(k) plan if your balance is over $5,000. And if you're changing jobs, you may also be able to roll your distribution over to your new employer's 401(k) plan.

- Though IRAs typically offer significantly more investment opportunities and withdrawal flexibility, your 401(k) plan may offer investments that can't be replicated in an IRA (or can't be replicated at an equivalent cost).
- 401(k) plans offer virtually unlimited protection from your creditors under federal law (assuming the plan is covered by ERISA; solo 401(k)s are not), whereas federal law protects your IRAs from creditors only if you declare bankruptcy. Any IRA creditor protection outside of bankruptcy depends on your particular state's law.
- 401(k) plans may allow employee loans.
- And most 401(k) plans don't provide an annuity payout option, while some IRAs do.

2. Not every distribution can be rolled over to an IRA.

For example, required minimum distributions can't be rolled over. Neither can hardship withdrawals or certain periodic payments. Do so and you may have an excess contribution to deal with.

3. Use direct rollovers and avoid 60-day rollovers.

While it may be tempting to give yourself a free 60-day loan, it's generally a mistake to use 60-day rollovers rather than direct (trustee to trustee) rollovers. If the plan sends the money to you, it's required to withhold 20% of the taxable amount. If you later want to roll the entire amount of the original distribution over to an IRA, you'll need to use other sources to make up the 20% the plan withheld. In addition, there's no need to taunt the rollover gods by risking inadvertent violation of the 60-day limit.

4. Remember the 10% penalty tax.

Taxable distributions you receive from a 401(k) plan before age 59½ are normally subject to a 10% early distribution penalty, but a special rule lets you avoid the tax if you receive your distribution as a result of leaving your job during or after the year you turn age 55 (age 50 for qualified public safety employees). But this special rule doesn't carry over to IRAs. If you roll your distribution over to an IRA, you'll need to wait until age 59½ before you can withdraw those dollars from the IRA without the 10% penalty (unless another exception applies). So if you think you may need to use the funds before age 59½, a rollover to an IRA could be a costly mistake.

5. Learn about net unrealized appreciation (NUA).

If your 401(k) plan distribution includes employer stock that's appreciated over the years, rolling that stock over into an IRA could be a serious mistake. Normally, distributions from 401(k) plans are subject to ordinary income taxes. But a special rule applies when you receive a distribution of employer stock from your plan: You pay ordinary income tax only on the cost of the stock at the time it was purchased for you by the plan. Any appreciation in the stock generally receives more favorable long-term capital gains treatment, regardless of how long you've owned the stock. (Any additional appreciation after the stock is distributed to you is either long-term or short-term capital gains, depending on your holding period.) These special NUA rules don't apply if you roll the stock over to an IRA.

6. And if you're rolling over Roth 401(k) dollars to a Roth IRA

If your Roth 401(k) distribution isn't qualified (tax-free) because you haven't yet satisfied the five-year holding period, be aware that when you roll those dollars into your Roth IRA, they'll now be subject to the Roth IRA's five-year holding period, no matter how long those dollars were in the 401(k) plan. So, for example, if you establish your first Roth IRA to accept your rollover, you'll have to wait five more years until your distribution from the Roth IRA will be qualified and tax-free.

Source: Broadridge

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1. Am I eligible to make a Roth IRA contribution?

To be eligible, you or your spouse must have compensation (generally earned income), and your income must be below certain thresholds. Furthermore, the maximum Roth IRA contribution amount of $5,500 ($6,500 for those 50 or older by the end of the year) for 2015 and 2016 is reduced by any contributions made to a traditional IRA.

2. Do I have money sitting in a taxable account that I can use to make a Roth IRA contribution?

If you have cash sitting in a savings or other bank account or cash or other investments in a taxable brokerage account, you're likely better off putting it to work in a Roth.

If the answer to both of the above questions is yes, then chances are that you're missing out on a great opportunity. When both answers are yes, there is almost no viable reason why you should not be making a Roth IRA contribution. Even if you need the money at some point, it's no problem. Roth IRA contributions can be distributed at any time, and for any reason, tax and penalty free. (Any earnings you withdraw, however, would be subject to taxes and penalties unless you are over age 59½ and your account has been open for at least five years.)

There aren't many opportunities to reduce future tax bills that come without an upfront cost, but Roth IRA contributions can be the exception to the rule. So before you file your 2015 tax return, and as you continue to plan for your 2016 return, make sure you're not passing up an opportunity to pad your Roth IRA savings without padding your tax bill.

Source: Kiplinger, by, Jeffrey Levine, CPA

Hidden Fees Investors Pay Non-Fiduciaries

The Department of Labor is soon expected to issue its much-ballyhooed, much-anticipated, and, in some circles, much-loathed "fiduciary rule."

This rule will require brokers who work with retirement accounts to act as, well, fiduciaries — in other words, to put their clients' interests ahead of their own. (Registered investment advisers are already held to a fiduciary standard.)

What could be simpler or less objectionable?

Yet brokers have fought the DOL's fiduciary rule since it was first proposed in April of last year. The rule is a small part of a larger sea change underway in financial services that will ultimately improve the quality and reduce the cost of investment advice, and brokers who are attempting to buck the trend will end up on the losing side of history.

How we got here is instructive. According to the DOL, its fiduciary rule is primarily for the benefit of middle-class and working-class investors. Why those folks in particular? Their retirement accounts tend to be smaller and therefore well suited to mutual funds, and with just one mutual fund a modest retirement account can be transformed into a diversified portfolio of hundreds of stocks and/or bonds.

There's just one dirty little secret at work here: Some mutual fund companies pay brokers a fee for selling their mutual funds to investors. Brokers aren't required to disclose these fees, so, surprise, surprise, they don't. Investors are left with the impression that brokers are recommending the best funds, when in reality brokers are likely pushing funds that pay them a fee.

This isn't just a harmless sleight of hand. The DOL estimates that these pay-to-play fees cost investors roughly 1% annually in forgone investment returns. This performance drag is a two-headed monster. For starters, the funds that pay these fees are generally more expensive than those that don't. Someone has to pay for the fees to brokers and that someone, of course, is the investor.

Wait, it gets better. Part of the fee is an annual commission that is paid to the broker for as long as the investor owns the fund. So not only are brokers incented to recommend unnecessarily expensive funds to begin with, but they are then incented to keep investors in those funds for as long as possible so they can keep their fee stream flowing.

Brokers would no doubt protest that these hidden fees don't influence their investment recommendations. Maybe so, but there is overwhelming evidence that expensive, actively-managed mutual funds favored by brokers are highly likely to underperform low-cost index funds. In just the latest in a long string of unflattering results, S&P's biannual SPIVA U.S. Scorecard reports that as of December 2015, 82% of large-cap mutual fund managers, 88% of mid-cap managers, and 88% of small-cap managers underperformed their benchmarks over the last 10 years.

Given these odds, why would anyone recommend expensive actively-managed mutual funds? Ah, yes, pay-to-play fees.

This is a suboptimal state of affairs in any context, but even more so when investors' retirement funds are at stake. Brokers could have forestalled the coming fiduciary rule by voluntarily disclosing pay-to-play fees to investors or — better yet — ending the practice altogether. But brokers clearly have no intention of doing either one of those things.

Instead, brokers have been content to push back with old-fashioned fear mongering. The fiduciary rule, they argue, will leave retirement investors worse off because brokers will either: 1) stop providing retirement advice to middle-class and working-class investors, or 2) charge investors higher fees for retirement advice to compensate for the greater burden imposed by the rule.

That's a false dilemma, my friends. There are already many financial companies that provide fiduciary retirement services with little or no investment minimums for a fraction of the cost of a high-priced, actively-managed mutual fund — and more are coming to market all the time. They include discount brokerages, investor-friendly mutual fund companies such as Vanguard, and online financial advisers known as robo-advisers.

That development alone should be a wake-up call for traditional brokerage firms. There is a new generation of financial companies that already lives up to the DOL's proposed standard. Moreover, they all are eager to efficiently and effectively serve the investors who traditional brokerages appear to be so cavalierly gouging or waving away.

Source: Investment News, by, Nir Kaissar

What is the Federal Funds Rate?

In December 2015, the Federal Open Market Committee (FOMC) raised the federal funds target rate to a range of 0.25% to 0.50%, the first shift from the rock-bottom 0% to 0.25% level where it had remained since December 2008.

The federal funds rate is the interest rate at which banks lend funds to each other from their deposits at the Federal Reserve, usually overnight, in order to meet reserve requirements. The Fed also raised a number of other rates related to funds moving between Federal Reserve banks and other banks. The Fed does not directly control consumer savings or credit rates, but the federal funds rate serves as a benchmark for many short-term rates, such as savings accounts, money market accounts, and short-term bonds.

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