Episode #322 – Order of Tax-Free Strategies Based on Income

Welcome back. If you're a high-income earner, then this video is for you. My name is Kyle, and you've probably heard the expression, “There are only two certainties in life, death and taxes.” While we may not be able to control death, how and when we die, we can control how much taxes we pay to the US government. In today's episode, I'm talking about 5 tax-free strategies for you to deploy in retirement ranging from the easy all the way to the complex strategies best left for financial professionals. Let’s look over to the board and get started.

If you make $100,000 of household income, you are considered the top 25% of the wealthy - whether you know or feel like you are wealthy or not. On the flip side of that, if you make over $500,000, you're a part of that prestigious 1%. The reason why I bring this up is because those top 1% of wage earners account for 36% of the overall tax revenue that the government collects each year. If you go across the board, if you're in that top 25% cumulatively, you are a part of 87% of the overall tax revenue. As I mentioned, these five strategies are going to help reduce future tax liability. I have them ranked from simple to complex based on your income, let's start with the first one.

That's your Roth IRA. We won't focus too much on this. This is your straightforward first option to build a tax-free retirement. There are some income and contribution limitations based on your age, around $7,000 or $8000. If you make too much money, about $240,000 of household income, you're phased out and can't actually fund. Now what's the next best option? We got the Roth IRA set up, what if I'm a higher-income earner, making over $100,000?

That's where you can take advantage of your Roth option inside your 401K. Now note, that 88% of plans out there today have this option where you can fund in more. Depending on your age over or under 50 it's either $23,000 or $30,500 which is imperative to know. Now this is where the rubber meets the road. So far those are two do-it-yourself strategies to take advantage of, but guess what? I hit that stop sign. I make too much money. I can't fund my Roth. What am I to do?

Due to your increasing income, we're going to start incorporating a financial planner or a financial professional to help guide you along these three next steps. The third option is what's called a backdoor Roth IRA. You're simply making after-tax, nondeductible, IRA contributions and immediately converting to a Roth IRA. Any amount or growth inside is taxed at ordinary income. While it's an option to put $7,000 or $8,000 into it, if you think about it, that contribution relative to your income is pretty insignificant. Not to mention the complexity around the pro rata rules that the IRS sets out, and the five-year access to the capital that you put in, and of course not to mention the stock market volatility, and risk to your principal.

That is where we're going to introduce that fourth step. If you haven't noticed already, this fourth step does not have any income or contribution limitations. Pretty good, right? That's what's called a max-funded indexed universal life policy. It's a hybrid life and cash value policy tied to an external index. A lot of wealthy individuals making over $250,000, $300,000 who fall on this side of the spectrum, are looking at different ways to dump in money that's going to grow tax deferred and be able to take out that money tax-free. It's transparent around cost. Our growth is tied to an index, but the only caveat there is that you have to have a standard or better health rating in order to qualify and really truly optimize the cash value aspect. The best thing of all, we can sidestep those pro rata rules and it's like a front-door Roth IRA if you think about it.

The final and the last and most complex strategy is the mega backdoor Roth IRA. Not too many people take advantage of this because it is somewhat rare to have a plan that allows three things where that criteria you have to meet. One, you have to have a plan that allows an in-service distribution. Two, you have to have a plan that allows for after-tax contributions, and third you must have already qualified or funded up to the 401K guidelines at $23,000 or $30,500. If those three things meet, you have an option and the ability to fund an additional $46,000 of the after-tax contributions into this plan. However, it is complex, not too many plans offer that, but it is an option for those ultra-high income earners to fund additional money inside their 401K.

Now what you've noticed is that I didn't mention an HSA or a 529. Those are also tax-free strategies, but they're unique because they're assigned to specific needs, whether it's health savings and expenses or college planning expenses.

Let's wrap up. We talked about the five different strategies and let's throw out an example of an individual who makes 3-4 or $500,000. He can't qualify for a Roth IRA. If there's a Roth option he's funding in this Max amount. If he can't qualify for the Roth, he's probably going to do the backdoor Roth IRA. We know there's complexity with the pro rata rules.

A lot of people who are looking for creative ways to grow tax-free have been using this fourth option, life insurance max funding up to the IRS guidelines in order to enhance that nest egg that we can eventually tap for cash value and future tax-free income and the best part about it is that there's no contribution or income limitations. One last question to leave you with. What if there were no income and contribution limitations, how much would you fund inside your IRA? If you have any questions, reach out to the financial professional who shared this video and have a conversation today. Thanks.