Back Door Roth IRA

Even wealthy people would be wise to have tax diversification, especially to combat sequence of return risk in retirement. However, many people in current high income tax brackets are loathe to give up the current deduction to achieve future tax-free income. Yet high income taxpayers who are active participants in a retirement plan may make too much money to deduct their IRA contributions. Their income may also be too high for a Roth IRA contribution. Enter the “back door” Roth IRA contribution. Essentially, the taxpayer contributes to a nondeductible IRA and then immediately converts it to a Roth IRA. Since the original contribution was not deducted, only the increase between the contribution and the conversion would be subject to income taxes. If the contribution included a commission, the earnings would have to be more than the commission. Thus, a back door Roth IRA contribution would seldom be a taxable event. Now the owner has the opportunity for tax-free growth as long as the eventual withdrawal is a qualified distribution.

This all seems very tempting, but, as usual, the devil is in the details.

If there are no other traditional IRAs and the person's AGI and active participant status prevents them from deducting IRA contributions or contributing to a Roth IRA, then a back door Roth IRA is easy. Contribute to the traditional IRA and then convert it quickly. You also must report the IRA contribution on the Form 8606 that is attached to that year's 1040. Now the person does not have a traditional IRA at the end of the conversion year. You can play this game for both spouses every year.

If one spouse has a traditional IRA and the other spouse does not, then fund the nondeductible IRA for the spouse without the traditional IRA first.

What about someone with a traditional IRA who still wants to do a backdoor Roth IRA?

The IRS sees each person as having a single IRA even if the money is in different accounts and different custodians. For example, Joe (age 52) works for an employer who always makes contributions to the firm’s retirement plan. He also has traditional deductible IRAs with the ABC Mutual Funds and also with the XYZ Mutual Funds. At the end of last year (2019), he had $10,000 with ABC and $83,000 with XYZ. His AGI is too large to deduct his contributions to a traditional IRA and also too large to contribute to a Roth IRA. Joe contributes $7,000 to a nondeductible IRA with a third mutual fund family. He then converts this money to a Roth IRA. He thinks, "I converted $7,000 from my third IRA and none of it was deductible so I do not have to pay income tax on any of it. I am da bomb.com!"

However, he may not be as much of da bomb.com as he thinks. Let's go thru the IRS calculation to see how much of the conversion is actually taxable in the end. Worksheet 1-1 is found on page 15 of the 2020 IRS Pub 590- b (https://www.irs.gov/pub/irs-pdf/p590b.pdf). Line 1 says to

enter the basis, not the value of the traditional IRAs at the end of the previous year. In this example, the basis is zero because all the traditional IRAs were deductible.

We will simplify the calculations by assuming there are returned contributions from previous years due to qualified disasters, birth or adoption withdrawals, etc. We will also assume there is no growth of any of the IRAs. We also assume there are no withdrawals/distributions other than the conversion of $7,000 to the Roth IRA.

In this case, Line 7 of Worksheet 1-1 on page 15 of IRS Pub 590-B is 0.070. That means 7% of the conversion is would be non-taxable and 93% of the conversion would be taxable.

Here are some conclusions:

1. The larger the traditional IRA balances at the end of the year, the larger the percentage of the conversion would be taxable. Thus, the amount of sheer joy from the conversion would be drastically reduced.

2. One strategy would be to move traditional IRAs into an employer plan (401(k), 403(b), etc.) and have the client's traditional IRA balance at the end of the year be zero. Thus, the nondeductible IRA conversion would be the only amount on Line 6 of the Worksheet. (Mollberg, 2013)

3. The retirement plan would need to accept the rollover of the traditional IRA. Also, if the advisor was only paid for the IRA and not the company retirement plan the advisor would be giving up assets under management. Thus, this is more of a strategy for people who are employed by both plans, like mutual fund employees and advisors who are paid for dealing with the employer's retirement account.

4. The rules are different for employer plans and IRAs if a couple undergoes a divorce and there are differences in the spouse's rights under the two types of accounts so these aspects would need to be considered. Still, for certain high income clients, the back door Roth IRA offers a painless ticket to tax free income in retirement. The sooner the contributions begin, the better.

Reference

Mollberg, K. T. (2013). Making a "Backdoor" Roth IRA Contribution. *Journal of Accountancy*, *215*(4), 72.