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Backdoor Roth IRAs

By: Daniel M. Haut, CFP®, CIMA®

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For middle to high income earners, there are IRS limitations on the tax benefits allowed for both Roth IRA and traditional IRA ownership.

For an individual with a modified adjusted gross income (MAGI) exceeding $135,000 (single filers) and $199,000 (married joint filers), the ability to contribute to a Roth IRA is completely phased out.[1] To add insult to injury, if the same individual decided to contribute to a traditional IRA in tandem with a work retirement plan (e.g. 401(k)), their contribution would not be tax deductible. Per IRS guidelines, single filers making over $72,000 and married joint filers making over $119,000 are phased out from IRA deductions if they contribute to a work retirement plan.[2]

At first glance, it would appear that middle to high income earners are locked out from the full tax benefits of both Roth IRA and traditional IRA ownership. Not to fret, however. There is a strategy that can provide a key to unlock many of these tax benefits by going through the proverbial back-door. In fact, with the passage of the Tax Cuts and Jobs Acts in 2017, Congress has left the backdoor wide open.

What is a "backdoor IRA conversion" and what is the benefit?

Simply put, a "backdoor Roth IRA" enables high income earners to bypass income limits by converting traditional IRAs into Roth IRAs. While contributing directly to a Roth IRA is restricted if MAGI exceeds limits, there are no limits to convert a traditional IRA to a Roth IRA.

Better yet, a backdoor Roth IRA conversion can allow an individual to convert a much greater amount than the annual Roth IRA contributions dictate. While the 2018 contribution limits are $5,500 ($6,500 for those over age 50), there are no limits for conversions.[3]

The benefits of Roth IRA conversion are many. Roth IRAs allow for growth and distributions to occur tax-free, assuming withdrawals occur after 5 years of ownership or age 59.5 – whatever is longer. Most importantly, the owner of a Roth IRA never has to take out required minimum distributions (RMDs) at age 70.5, which allows the tax-deferral to stretch.

Non-Deductible IRAs are Great Candidates, but Beware the Pro-Rata Rule!

To be clear, a backdoor Roth IRA conversion does not evade taxes. In order to convert a traditional IRA to a Roth IRA, one must pay taxes on the amount they're converting.

Due to the large tax obligation that can occur as a result of conversion, the best candidates for a back-door Roth IRA conversion are those with non-deductible IRAs.

As mentioned at the beginning of the article, when an individual has a MAGI that exceeds IRS limits and contributes to both a work retirement plan and traditional IRA, any contributions are post-tax. For individuals with a significant amount of non-deductible IRA monies, a back-door Roth conversion is a logical strategy. Unlike a Roth conversion from a deductible IRA which results in a tax on 100% of conversion, a Roth conversion from a non-deductible IRA results in a much smaller tax bill to Uncle Sam.

However, one still must be aware of the IRS pro-rata basis rule.[4] The prorata basis rule states that the IRS looks at the entire traditional IRA balance when determining the basis of the converted Roth IRA.

Example: Karen contributes to both her traditional IRA and her work 401(k). She is a married joint filer with a MAGI of over $199,000 per year. Due to her income, her previous IRA contributions have all been non-deductible or post-tax. The value of her IRA is $100,000 of which $65,000 consists of non-deductible contributions and $35,000 of growth. Since Karen's income precludes her from contributing to a Roth IRA directly, she decides to do a back-door Roth conversion with the $65,000 of non-deductible IRA monies. Since the IRS looks at the entire IRA balance when doing the conversion, this means that 65% of the new Roth IRA or $42,250 ($65,000 x 65%) will be considered after-tax basis. The remaining $22,750 ($65,000 x 35%) will be considered taxable income for the year of conversion. Assuming Karen is in the 24% marginal tax bracket, this means that $5,460 in taxes ($22,750 x 24%) will be due. However, this is a small price to pay as future withdrawals from the newly converted Roth IRA are tax free and the IRS won't mandate required distributions at age 70.5.

Avoiding the Pro-Rata Basis Rule

This pro-rata basis rule does not apply if you have your other retirement monies in a qualified plan like a 401(k).

Example: Lia has a work 401(k) valued at $500,000 but has not yet contributed to a traditional IRA. She earns over the limit to qualify for direct contribution into a Roth IRA. Lia can open and fund a non-deductible IRA with $5,500 – she is over the limit for deductible contributions as well – and fund it with post tax dollars. She can then convert 100% of the non-deductible IRA to a back-door Roth IRA. The entire Roth IRA is considered basis since the 401(k) does not count as part of the pro-rata basis rule.

Another strategy is to roll over only deductible IRA monies into your 401(k) and leave the non-deductible monies in the IRA. This would avoid the pro-rata basis rule altogether.

Example: Jim owns an IRA with a balance of $250,000. Of this balance, $100,000 is in non-deductible contributions and $150,000 is in tax-deferred growth. If Jim has a 401(k) and the adoption agreement allows it, he can rollover $150,000 of his deductible monies into his 401(k) and leave the $100,000 of non-deductible monies in his IRA. He can then do a backdoor Roth conversion of the $100,000 non-deductible IRA contributions and avoid the pro-rata basis rule altogether!

While the backdoor Roth conversion strategy may be beneficial for middle to high income earners, it may not make sense for everyone. It is important that you consult with your financial planner or CPA before executing this strategy.

[1] https://www.irs.gov/retirement-plans/plan-participant-employee/amount-of-roth-ira-contributions-that-you-can-make-for-2018
[2] https://www.irs.gov/retirement-plans/2017-ira-deduction-limits-effect-of-modified-agi-on-deduction-if-you-are-covered-by-a-retirement-plan-at-work
[3] https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-contributions
[4] https://www.irs.gov/retirement-plans/rollovers-of-after-tax-contributions-in-retirement-plans