

Back-Door Roth IRAs

Article Highlights:

- Roth IRA Contribution Limitations
- Converting a Traditional IRA to a Roth IRA
- Circumventing the Limitations
- Back-Door Roth IRAs
- Pitfalls of a Back-Door Roth IRA
- The "All IRAs Are One" Rule

Many individuals who are saving for retirement favor Roth IRAs over traditional IRAs because the former allows for both accumulation and post-retirement distributions to be tax-free. In comparison, contributions to traditional IRAs may be deductible, earnings are tax-deferred, and distributions are generally taxable. Anyone who is under age 70.5 and who has compensation can make a contribution to a traditional IRA (although the deduction may be limited). However, not everyone is allowed to make a Roth IRA contribution.

High-income taxpayers are limited in the annual amount they can contribute to a Roth IRA. The maximum contribution for 2016 is \$5,500 (\$6,500 if age 50 or older), but the allowable 2016 contribution for joint-filing taxpayers phases out at an adjustable gross income (AGI) between \$184,000 and \$194,000 (or an AGI between \$0 and \$9,999 for married taxpayers filing separately). For unmarried taxpayers, the phase-out is between \$117,000 and \$132,000.

However, tax law also includes a provision that allows taxpayers to convert their traditional IRA funds to Roth IRAs without any AGI restrictions. Although deductible contributions to a traditional IRA have AGI restrictions (for those who are in an employer's plan), nondeductible contributions do not.

Thus, higher-income taxpayers can first make a nondeductible contribution to a traditional IRA and then convert that IRA to a Roth IRA. This is commonly referred to as a "back-door Roth IRA."

BIG PITFALL: However, there is a big pitfall to back-door IRAs, and it can produce unexpected taxable income. Taxpayers and their investment advisers often overlook this pitfall, which revolves around the following rule: For distribution purposes, all of a taxpayer's IRAs (except Roth IRAs) are considered to be one account, so distributions are considered to be taken pro rata from both the deductible and nondeductible portions of the IRA. The prorated amount of the deducted contributions is taxable. Thus, a taxpayer who is contemplating a back-door Roth IRA contribution must carefully consider and plan for the consequences of this "one IRA" rule before making the conversion.

There is a possible, although complicated, solution to this problem. Rolling over IRAs into other types of qualified retirement plans, such as employer retirement plans and 401(k) plans, is permitted tax-free. However, a rollover to a qualified plan is limited to the taxable portion of the IRA. If an employer's plan permits, a taxpayer could roll the entire taxable portion of his or her IRA into the employer's plan, leaving behind only nondeductible IRA contributions, which can then be converted into a Roth IRA tax-free.

Before taking any action, please call this office to discuss strategies for making Roth IRA contributions or to convert existing traditional IRAs into Roth IRAs.