The Back-Door Roth IRA

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Urban legend – "I make too much to have a Roth IRA."

Q: Do I make too much to be able to contribute to a Roth IRA?

A: Perhaps. The IRS dictates that in order to contribute to a Roth IRA in 2018 one must earn less than $125,000 (phase-out between $120,000 and $135,000), and couples must earn less than $199,000 (phase-out between $189,000 and $199,000).

Q: Well that's me. Do you have another idea?

A: Yes. Why not open a non-deductible IRA and then convert it to a Roth IRA? This idea is popularly referred to as the "back-door Roth IRA".

Q: Back door – that sounds like a Creedence Clearwater song. Why not just make Roth 401(k)/403(b) contributions?

A: Thanks – now I can't get the song out of my mind! You may be able to make Roth contributions to your 403(b) or 401(k). Some employers, typically non-profits, offer 403b plans while most offer 401k plans. Some offer each and some do not make Roth contributions available. To determine if a Roth contribution is available and into which employer retirement account, check with your benefit department.

Making Roth contributions to your employer retirement plan will decrease the tax benefit you would normally receive by making pre-tax contributions, so a trade-off is involved. You either reduce your current income tax or reduce the tax you and/or your beneficiaries pay in the future. Generally, the younger a person's age, the more appealing a Roth 403b or 401k contribution may be.

Q: Figures. There's always a trade-off. Well this seems like a lot of work anyway. Remind me of why Roth savings are so special?

A: Money invested in a Roth account grows tax free and can be withdrawn in the future without income taxes. It is quite common now-a-days for a person to retire and live another thirty years. This is a long time to provide for income.

Q: So not having to pay income tax will allow me to stretch out my income over a longer period of time or allow me to receive a greater amount of income. What if I end up not needing the Roth money?

A: Your beneficiaries will inherit the Roth money, and when they take withdrawals they won't have to pay income tax either. Furthermore, with a Roth IRA you will not be required to take distributions once you turn 70 ½ as you would with a traditional IRA or pre-tax employer retirement plan.

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Q: I see your point; the Roth IRA may provide retirement income for me as well as potentially for my children and others. And everyone will potentially save a lot in taxes over time. Too bad the tax trade-off exists for my employer retirement plan contributions.

A: There are a few strategies that will let you "have your cake and eat it too." Why not continue to make pre-tax contributions to your employer retirement plan and make contributions to a traditional IRA and convert it to a Roth IRA? Regardless of how much you earn, you are always able to make non-deductible IRA Contributions.

Q: I work for a non-profit. How does my 457 plan fit into this?

A: Glad you asked. You may only make pre-tax contributions to the 457 plans. So why not max out your 457 contribution, thereby receiving a tax benefit today, and make Roth contributions to your 401(k)/403(b)?

Q: Sounds good. Is there a tax-related deadline to opening/contributing to an IRA?

A: The normal tax-filing deadline of April 15th.

Q: How much may I contribute?

A: In 2018, those under 50 may contribute $5,500; those 50 and older $6,500. Non-working spouses may also make contributions to an IRA. There are no age limits for making contributions so if a child or a retiree has earned income, a contribution is allowable.

Q: Are there any catches to this strategy?

A: Yes. First, you would need to be eligible to make an IRA contribution meaning you have earned income.

Next, if you have other IRA dollars, the conversion may be partially taxable due to the "pro-rata" rule. Let's consider an example.

You have $45,000 in existing deductible IRA contributions in one IRA, and you make a $5,000 non-deductible contribution into a new IRA in order to eventually convert it into a Roth IRA. Your new IRA, however, would only represent 10% of your total IRA value of $50,000. You will not be able to convert only the non-deductible IRA but will have to convert a proportional amount of the deductible IRA as well resulting in a greater taxable liability than desired.

Q: That's quite a catch! So, if I am not careful my Roth conversion could result in a much larger tax bill. Of course you have a way around this, right?

A: Yes, there is a way to reduce, if not eliminate, your exposure to the pro rata rule. If you have a retirement plan through your employer, you may be able to transfer your deductible IRA balance into the plan thereby solving the pro-rata dilemma.

One other thing of which to be aware: you will need to file Form 8606 with your tax return. This form is used to report after-tax IRA contributions as well as the pro-rata calculations.

I suggest you talk with a CERTIFIED FINANCIAL PLANNER™ and a tax advisor to review your personal situation to determine if the Back-Door Roth Strategy is right for you as well as the tax ramifications of using it.

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Consider how you may use the Back-Door Roth strategy to improve your financial future.

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