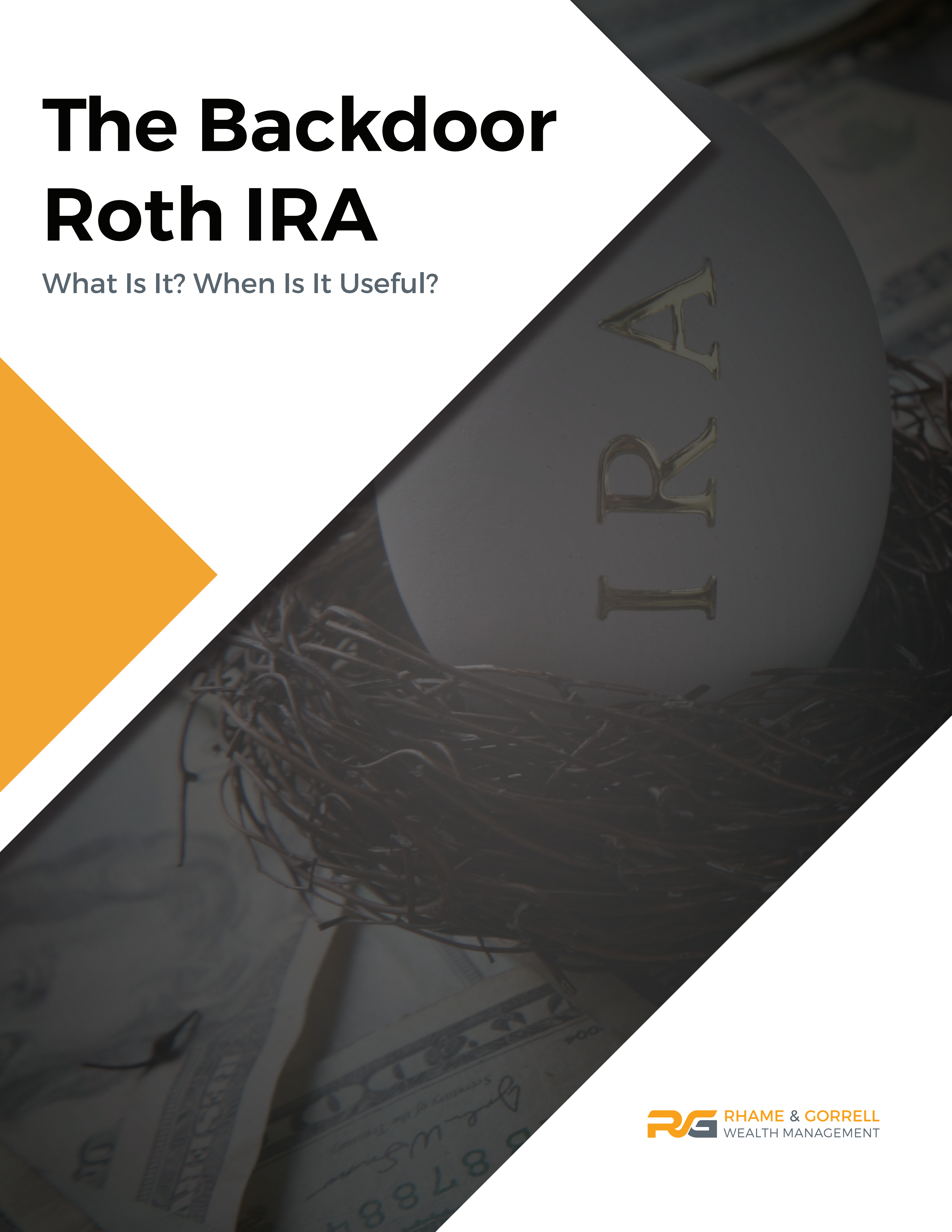
The Backdoor Roth IRA

What Is It? When Is It Useful?



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The Backdoor Roth IRA:
What Is It? When Is It Useful?

The Individual Retirement Arrangement (IRA) is a savings account with tax advantages that individuals can use to save and invest for retirement. There are two primary types of IRA: ***Traditional*** *and* ***Roth****. In a typical Traditional IRA, a taxpayer makes tax deductible contributions (i.e., pre-tax contributions), the investment growth is tax deferred and the money is subject to ordinary income tax when withdrawn. In a Roth, it's the opposite: contributions are non-deductible but the growth is generally tax-free upon withdrawal.*

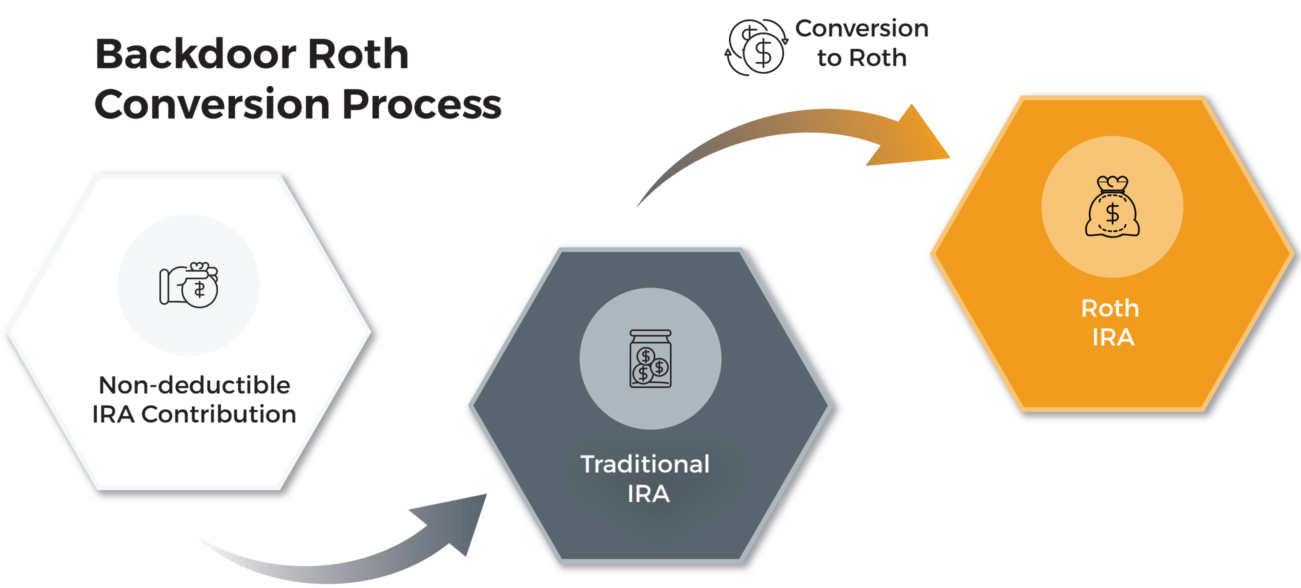
High-income earners are disallowed from making pre-tax contributions to a Traditional IRA if 1) their modified adjusted gross income exceeds certain thresholds, and 2) they are covered by an employer sponsored retirement plan. Taxpayers who are ineligible to make pre-tax contributions to a Traditional IRA can still make contributions, but these contributions are treated as non-deductible contributions.

High-income earners are also disallowed from making contributions to a Roth IRA when their modified adjusted gross income exceeds certain thresholds.

In 2010 Congress changed the rules governing the conversion of a Traditional IRA to a Roth IRA by eliminating the income restrictions and allowing all taxpayers, regardless of income, the ability to convert their Traditional IRA to a Roth IRA.

For high-income earners who are not eligible to make regular Roth IRA contributions, they can make non-deductible contributions to a Traditional IRA and then convert to a Roth IRA. The conversion results in ordinary income taxes only on the amount in excess of the taxpayer's non-deductible contributions. This process is oftentimes referred to as **The Backdoor Roth IRA**.

Backdoor Roth Conversion Process



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The process only makes sense for those individuals who have income that precludes them from directly contributing to a Roth or deducting their Traditional IRA contribution. For 2021, this means:

- If tax status = Single and MAGI > $125k
- If tax status = Married and MAGI > $198k

There are a few potentials issues to be concerned with:

The Aggregation Rule	If the taxpayer has other pre-tax Traditional IRA money, they will have topay tax on the converted IRA on a pro-rata basis. For example, if a taxpayer has a Traditional IRA with $95,000 of money from a 401(k) rollover (the $95,000 contributions were made on a pre-tax basis), and the taxpayer makes a $5,000 non-deductible contribution to a new Traditional IRA, the conversion would be 95% taxable. This can be avoided by rolling the $95,000 Traditional IRA into the taxpayer's employer sponsored retirement plan. Not all custodians allow this type of rollover.
Form 8606	Taxpayers who make non-deductible contributions to a Traditional IRA and/or convert a Traditional IRA to a Roth IRA must file Form 8606.
The Step-Transaction Doctrine	This is the legal principle that a series of related steps in a transaction should be combined into one single step and taxed based on the overall economic nature of the transaction, not taxed based on the separate individual steps. The concern is that the IRS would treat the converted amount as a direct contribution to the Roth IRA. The IRS's informal position is that the Backdoor Roth IRA strategy is not a problem. However, taxpayers may wish to wait some time between the contribution to the Traditional IRA and the conversion to the Roth IRA.

The Roth IRA is among the most tax advantageous investment vehicles allowed by the government. Amounts in the account grow tax-free and can be withdrawn tax-free. In addition, amounts withdrawn are not counted for purposes of calculating Medicare premiums, are not subject to RMDs, and do not affect the threshold for the new 3.8% Medicare contribution tax. Prior to engaging in this strategy, a number of factors must be taken into account including other Traditional IRA assets, state tax issues, and potential IRS scrutiny of the transaction.

If you'd like some help from a CERTIFIED FINANCIAL PLANNER ™ (CFP®) regarding this strategy and how it could be effective for you, the Rhame & Gorrell Wealth Management team is here to help. Contact us at (832) 789-1100, service@rgwealth.com, or rgwealth.com/lets-get-started/ today to schedule your complimentary strategy session.