Schwartz Financial Services

Comprehensive Wealth Management & Retirement Planning

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Backdoor Roth IRAs: A Potential Way for High Income Earners to Participate in Roth IRAs

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We are interested

In working with you.
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(215)886-2122
to see if you could benefit from our services.

Annual Holiday Open House

(Families Welcome!)
Sunday December 13, 2015
115 Old York Road
Jenkintown, PA 19046

February 2016

Welcome to 2016 Presentation
More information to come soon

The traditional contribution ("front door") for Roth IRAs is currently not available for higher income earners. Married couples earning $193,000 or more and singles earning $131,000 or more in 2015 are still barred from contributing directly to Roth IRAs.

In 2010, Congress changed the rules and since then anyone can convert a traditional IRA to a Roth IRA. However, higher income earners are still ineligible to contribute to a Roth IRA.

A Backdoor Roth IRA is a strategy for some higher income earners to participate in Roth IRAs. It is a way for higher income earners to put money into a traditional IRA and then roll that into a Roth IRA, getting all the benefits. While this strategy sounds simple, there are several rules that you must know and follow to make sure you do not incur unintended tax consequences. This is where working with a knowledgeable financial or tax professional can provide some great guidance and value.

One of the primary benefits of a Roth IRA is that any money contributed grows tax-free and is withdrawn without any further income taxation. In addition, unlike a traditional IRA, Roth IRAs have no required lifetime minimum distributions. Another benefit of a Roth IRA is it can be passed on to your heirs income tax free. This allows your funds to grow and compound tax free over many years.

How Does the Backdoor Roth IRA Conversion Work?

The backdoor Roth conversion consists of two simple steps:

1) You make a nondeductible contribution to your traditional IRA.

2) Within a couple of days you convert this IRA into a Roth IRA (potentially paying little to no taxes on the conversion).

There's one big caveat: This strategy works best tax-wise for people who don't already have money in traditional IRAs. That's because in conversions, earnings and previously untaxed contributions in traditional IRAs are taxed—and that tax is figured based on all your traditional IRAs, even ones you aren't converting (Please read the section on the Pro Rata Rule).

For an investor who doesn't already hold any traditional IRAs, creating one and then quickly converting it into a Roth IRA will incur little or no tax, because after a short holding period there's likely to be little or no appreciation or interest earned in the account. However, if you already 2016 tax deadline. This non-deductible IRA can then be used for your backdoor Roth IRA conversion (please call us prior to doing so because the rules for Roth conversions can be complicated).

Example of a Backdoor Roth IRA

Bill, a high income earner decides on January 2nd to put $5,500 into a traditional IRA for himself and another $5,500 into a traditional IRA for his wife Mary. Bill's income is too high to be able to deduct these contributions from his taxes. So the next day, he converts the traditional IRAs to Roth IRAs completely tax-free. His income is too high for him to make a direct contribution into a Roth IRA, but there's no income limit on conversions! Since Bill and Mary couldn't deduct the contribution anyway, they might as well get the advantage of never paying taxes on that money again available through the Roth IRA.

Bill's Backdoor Roth IRA Conversion without Additional IRAs		
Contribution to Non- deductible traditional IRA	Convert to Roth IRA	Income Subject to Taxation
$5,500	**$5,500**	**$0**

if they are in different accounts), not just the traditional IRA you are converting to a Roth IRA, and will determine what your tax bill will be based upon a ratio of IRA assets that have already been taxed to those IRA assets in total.

The IRS determines the tax on this conversion based on the value of *all* of your IRA assets. For example Jane, a high income earner, already has $94,500 in an IRA account, all of which has never been taxed. She decides on January 2nd to put $5,500 into a new traditional IRA. The next day she converts the new traditional non-deductible IRA to a Roth IRA. Jane's income is too high for her to have money in traditional deductible IRAs, you could face a far higher tax bill on the conversion (again, this is covered later in the section on the Pro Rata Rule).

If you choose to, you can contribute to a non-deductible IRA for 2015 (the maximum is $5,500 or $6,500 for those age 50 or older). Remember, you must contribute to your IRAs prior to the April 15

This is a hypothetical example and is not representative of any specific investment. Your results may vary.

Beware of the Pro Rata Rule for Roth Conversions

What is the Pro Rata rule for Roth conversions?

The Pro Rata rule for Roth conversions states that if you have any other deductible IRAs (i.e. a previous 401k that you've rolled over), the conversion of any contributions becomes a taxable event that you'll need to pay taxes on upfront.

The Pro Rata rule for Roth conversions determines whether or not your conversion will be taxable! For taxation purposes, the IRS will look at your entire IRA holdings (even make a direct contribution into a Roth IRA, but there's no income limit on conversions. Unlike Bill she has $94,500 in other IRAs (previously non-taxed), so her total IRA assets are now $100,000. When she converts $5,500 to a Roth IRA, the IRS pro-rates her tax basis on the previous taxation of her total IRA assets, therefore making this conversion 94.5% taxable ($94,500/100,000 = 94.5%).

Jane's Backdoor Roth IRA Conversion			
Balance in All IRAs	Contribution to Non-deductible traditional IRA	Convert to Roth IRA	Income Subject to Taxation
$94,500	**$5,500**	**$5,500**	**$4,750**

This is a hypothetical example and is not representative of any specific investment. Your results may vary.

So if you plan on using this backdoor IRA strategy, you want to be clear as to whether or not you have any other IRAs. As you can see, this can be a confusing area and this is where we can help. If you are a high income earner we would be happy to review your situation to determine if this strategy is in your best interest.

Also, please remember that your spouse's IRA is separate from yours.

Benefits of a Roth IRA

There are numerous benefits to converting to a Roth IRA. Please remember, it is important to review all of your retirement accounts before converting to a Roth IRA. Some benefits of a Roth IRA include;

- Required minimum distributions are not obligatory until the participant's death.
- Withdrawals are tax free.
- They pass onto your heirs income tax-free.
- You can compound your investments in a tax-free fashion.

Am I a Candidate for a Backdoor Roth IRA?

Backdoor Roth IRAs can be appropriate for investors who:

- Only have retirement account through their jobs (i.e. 401k's) and want to increase their retirement savings in tax-advantaged accounts, but whose income is too high to qualify for standard Roth IRA contributions; and
- Have the time and ability to wait for five years or until they are 59 ½ to avoid the 10% penalty on early withdrawals. (If you open and make contributions to a Roth IRA in the standard manner, i.e. not through conversion, you are not subject to this rule).

A Backdoor Roth IRA is probably *not* recommended if you:

- Are over the age of 70½ and can no longer contribute to a traditional IRA.
- Don't want to contribute more than the maximum retirement limit through your workplace retirement account.
- Already have money in a traditional IRA and because of the Pro Rata rule may end up in a non-tax advantageous position when converting to a Backdoor Roth IRA.
- Plan or expect to withdraw the funds in the Roth IRA within the first five years of opening it. A Backdoor Roth is considered a conversion and not a contribution. Therefore, the funds will incur a 10% penalty if withdrawn within five years unless you are age 59 ½ or older.
- Are in a high tax bracket now and expect to be in a lower tax bracket in the future.
- Plan to relocate to a lower- or no- income tax state.

Recharacterizations

Converting to a Roth IRA also comes with another very unique advantage. The IRS allows you a one-time opportunity to recharacterize or "undo" this conversion by October 15th of the following tax year. IRS publication 590 states that, "a recharacterization allows you to 'undo' or 'reverse' a rollover or conversion to a Roth IRA. To recharacterize, you generally instruct the trustee of the financial institution holding your Roth IRA to transfer the amount back to a traditional IRA (in a trustee-to-trustee or within the same trustee). If you do this by the due date for your tax return (including extensions), you can treat the contribution as made to the traditional IRA for that year (effectively ignoring the Roth IRA contribution)". In the case of a Backdoor Roth IRA, you probably won't think about recharacterizing. However, if you want to explore this option, we are here to help assist you, because like many of the other rules involved this can be complicated.

Conclusion

A Backdoor Roth IRA is a strategy that can be useful for the right investor. Currently, there are proposals to close down this opportunity. However, as of today, it is still available. While Backdoor Roth IRAs can be beneficial to many investors, they aren't for everyone. They come with their limitations and complications. There are precautions that need to be taken to reap the full benefits of any financial decision. This is an area where a highly informed financial advisor can help you make an educated and calculated decision. You should always consult with your financial advisor and tax professional to help avoid tax ramifications.

As always, we are here to help and can look at your specific financial situation and chart the right path for you. If you are interested in learning more about whether or not a Backdoor Roth would be right for you and your specific situation, please call us and we would be happy to discuss this with you. As always, we enjoy the opportunity to assist you in addressing your financial matters.

If you'd like a copy of this article sent to someone else who would benefit from this information, please contact Lyndsey at Schwartz Financial at 215-886-2122

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- Bring a guest to one of our workshops
- Share the news of our complimentary consultations

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