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# Back-door Roth IRA

## Quick Summary

- A backdoor Roth IRA allows you to get around income limits by converting a Traditional IRA into a Roth IRA.
- Contributing directly to a Roth IRA is limited if your income is beyond certain limits, but there are no income limits for conversions.
- The amount of Roth IRA contributions is normally limited, but a backdoor Roth IRA has no limits on the amount of the conversion.

## Introduction

Roth IRAs are a unique and powerful way to save for retirement. You pay taxes upfront on a Roth IRA, but after that, all growth and withdrawals are tax-free in a Roth IRA.

But people who make too much money aren't allowed to open Roth IRAs -- under the regular rules, anyway. If you think tax-free income in retirement will be important to you, but you make too much to open a Roth, you might want to consider the backdoor. In a backdoor Roth, you first make a contribution to a Traditional IRA and then convert it to a Roth IRA.

## What exactly is a backdoor Roth IRA?

A backdoor Roth is a conversion of Traditional IRA assets to a Roth IRA. Currently, anyone can convert money that you have put into a Traditional IRA to a Roth IRA no matter how much income you are making. You can also roll as much money as you want from a Traditional IRA into a Roth IRA, exceeding the contribution limits on IRAs.

Keep in mind this isn't a tax dodge. You will need to pay taxes on any money in your Traditional IRA that hasn't already been taxed. The funds that you convert to a Roth IRA will most likely count as income, which may affect the tax rate that you pay on your other sources of income so you need to carefully consider whether a Roth IRA conversion is right for you.

You can do a backdoor Roth IRA in one of two ways. Either you can contribute money to an existing IRA, sell shares and then roll over the money to Roth IRA account. Or, you can convert an entire Traditional IRA account to a Roth IRA account. Your bank or brokerage should be able to help you with the mechanics. Your Traditional IRA doesn't have to be new. You can roll over existing Traditional IRA money, or an old Traditional IRA account into a Roth.

# Is a backdoor Roth IRA right for me?

The main advantage of a Roth IRA is that you pay taxes upfront, but that everything after that is tax-free. This is most beneficial when you taxes are lower now than you expect in the future.

A backdoor Roth IRA lets you get around:

a) Roth IRA Income limits: In 2015, if you earn more than $131,000 (single) or $193,000 (married), you may not contribute to a Roth IRA. These limits do not apply to Roth IRA back-door conversion.

b) Roth IRA Contribution limits: Normally, you may contribute only $5,500 ($6,500 if you are over 50) to a Roth IRA. With a backdoor Roth IRA conversion, these limits do not apply

If your income is beyond these limits or if you want to contribute more than allowed, a back door Roth IRA is the only way to do so.

Whether or not this is a good idea depends on your own situation. If, for example, you have a gap in employment and your income is unusually low, doing a back door Roth could be a great way to take advantage of this situation.

# Will there be tax implications to my backdoor Roth?

The government wants to collect its taxes, one way or another. A backdoor Roth is not a way to escape taxes. The amount of taxes you owe on a backdoor Roth could range from none, to a high tax bill. Most people who convert money to a Roth IRA via the backdoor need to learn what the pro-rata rule is and how it applies to their conversion.

The key questions are:

- Are you converting money on which you have taken a tax deduction?
- Are you converting non-deductive contributions, money that you contributed after you paid taxes on it?
- Are you converting your entire retirement portfolios to a Roth, or keeping some money in Traditional IRAs, or SEP or SIMPLE IRAs? If you are keeping some money in Traditional IRAs, you will be subject to the pro-rata rule.
- Are you converting money on which you have taken a tax deduction?

If you convert a Traditional IRA, money on which you have already received an income tax deduction, to a Roth IRA, you will owe taxes on the entire amount that you convert. If you contribute $5,500 to a Traditional IRA and then convert the money to a Roth IRA, you will owe taxes on the $5,500, plus on whatever money it earns between the time you contributed to the Traditional IRA and converted to a Roth IRA. If you have saved $500,000 in a Traditional IRA, and convert the entire $500,000 to a Roth, you will owe taxes on the $500,000.

Are you converting non-deductive contributions to a Traditional IRA, money that you contributed after you paid taxes on it?

You can make non-deductible contributions to a Traditional IRA and convert the money on which you've already paid taxes to a Roth IRA. This is how you can exceed the contribution limits to your IRAs: The government doesn't care how much money you put into IRA, as long as you pay taxes on the amount that is more than the contribution limit, $5,500 or $6,500 if you are over 50. If you convert non-deductible Traditional IRA contributions to a Roth, you won't pay taxes.

Are you converting your entire retirement portfolios to a Roth, or keeping some money in Traditional IRAs, SEP or SIMPLE IRAs?

If you convert some money to a Roth IRA and keep some money in other kinds of IRAs, you don't owe taxes simply on the converted amount. Instead, you owe taxes based on the proportions of your money that is after-tax and before tax.

To figure out how the pro rata rule applies to you, figure out how much money in your IRA accounts is pre-tax and how much is after tax. Treat all of your IRAs like one big IRA for this purpose. Say you have a total of $100,000 in all of your accounts, and $10,000 of it is money you put in after taxes. You will owe taxes on 90% of the money you convert to a Roth.

How does this play out? Here are two examples, taken from Ed Slott's Definitive Guide to the Back-Door Roth. Basically, if only a small proportion of your overall retirement assets are non-deductible, you will face a higher tax bill for your conversion.

Example 1

Jake has $100,000 in his traditional IRA, $10,000 of which is after-tax. Therefore, 10% ($10,000 / $100,000 = 10%) of his traditional IRA consists of after-tax money. If Jake wants to convert $20,000 of his Traditional IRA to a Roth IRA, $2,000 ($20,000 x 10% = $2,000) would be tax-free. The remaining $18,000 ($20,000 - $18,000 = $2,000) would be taxable.

Example 2

Ann has $95,000 in her traditional IRA, all of which is pre-tax. If Ann makes a $5,000 nondeductible (after-tax) contribution to a traditional IRA, her total IRA balance will be $100,000, $5,000 of which will be after-tax. Thus, only 5%

($5,000 / $100,000 = 5%) of her Roth IRA conversion – will be tax-free. If Ann converts $5,000 from her traditional IRA to a Roth IRA after making her nondeductible contribution, just $250 would be tax free ($5,000 x 5%), while the remaining $4,750 ($5,000 -$250 = $4,750) would be taxable. Ann would still owe tax on the $5,000 she contributed to the traditional IRA.

# Will backdoor Roth IRAs always be available?

Roth IRAs, and all tax policy, is subject to change and the availability of backdoor Roth IRAs is definitely a question mark.

Roth IRAs were initially envisioned as a way for people to save for retirement but still be able to access the money without penalties. It was thought that being able to withdraw money without penalties would attract younger savers.

At first, eligibility was limited. Whether you wanted to open a Roth IRA or convert an existing IRA into a Roth, you had to be beneath the income limit. Only people making less than $100,000 a year could convert their plans. Opening a Roth IRA is still limited to lower-income savers.

But the conversion cap was removed as older and higher-income investors asked for the benefit of tax-free withdrawals in retirement. Roths can also be passed down to your beneficiaries after your death.

The backdoor Roth remains a subject of debate over the long term so if you want to take advantage of this strategy, you may want to do so before policy changes.



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