Back Door Roth

A Saving Strategy for Higher Earners

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BECAUSE THEY ARE TAX-ADVANTAGED, IRAs have become a favorite way to save for retirement. You can contribute up to $6,000 a year ($7,000 if you're age 50 or older) — or $12,000 for a married couple — of tax-deductible income to your IRA, watch your money grow over the years, and only pay tax on it when you start withdrawing those dollars in retirement. A Roth IRA is even more attractive to many people because you contribute after-tax dollars and the earnings grow tax-free — when you withdraw funds in retirement you pay no income tax on your withdrawals.

The IRS is not so eager to lose too much tax money, so they have put restrictions on who can contribute to a Roth IRA. The annual contribution limits are the same as a traditional IRA, but if you earn more than $137,000 as an individual taxpayer, or $203,000 married filing jointly (based on 2019 tax law), you can't contribute to a Roth IRA. You'll have to find another retirement savings vehicle, one not likely to offer the same tax advantages of a Roth IRA.

Unless, that is, you employ a strategy known as the Back Door Roth. Here's how it works:

You open a traditional IRA account with your contribution of up to $6,000 as an individual, $12,000 if you are married and filing your tax return jointly. Then you immediately convert the traditional IRA to a Roth IRA. Because you are contributing non-deductible, after-tax dollars to the IRA there is no tax or penalty associated with the conversion. Just like other Roth plans, money in your Back Door Roth grows tax-free. And you can continue to make the maximum contribution annually in the same manner: funding a traditional IRA and converting.

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There is one caveat. You cannot employ the strategy if you own existing traditional IRA assets. The IRS considers all your IRA savings as one combined amount, so converting even a new IRA contribution under those circumstances will make the conversion a taxable event, just as it would be if you were to withdraw money from your existing IRA. If you have traditional IRA assets and want to deploy a Back Door Roth strategy, you must transfer your existing IRA dollars elsewhere, perhaps to an employer sponsored 401k or 403b plan.

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Due to the tax benefits, IRAs have become a favorite way for Americans to save for retirement. An estimated $10 billion of a near $30 billion in retirement savings in the U.S. are currently invested in IRAs. The Back Door Roth allows higher earners, otherwise unable to enjoy the benefits of an Roth IRA, to participate in this most popular of savings plans.

For more information, or to schedule an estate planning meeting, call us at 772-287-4110; or email me at SSwindler@hbkswealth.com.

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