Is a Backdoor Roth Conversion Right For You?

Roth IRAs are one of the most versatile retirement investment vehicles available. Because they were originally intended to aid young and low-income workers in saving for retirement, Roth IRAs have income limits. For 2020, the government allows only those people with modified adjusted gross incomes below $206,000 (for married couples filing jointly) or $139,000 (for single filers) to contribute to a Roth IRA. In 2021, the limits have been raised slightly to $208,000 (married filing jointly) or $140,000 (single). However, a loophole in tax law allows even high-income earners to take advantage of a Roth IRA by doing what is known as a backdoor Roth conversion.

In considering if this is the right move for you, it is important to consider the advantages Roth IRAs have. Roth IRAs have three major benefits over traditional IRAs. The first is that you can enjoy tax-free withdrawals in retirement. Contributions to traditional IRAs are tax-deductible, but the withdrawals taken in retirement are taxed as income. With a Roth IRA, you contribute post-tax dollars. This means that your money can grow tax-sheltered and, so long as you follow the Roth IRA guidelines, can be withdrawn tax-free. The second advantage is that Roth IRAs have no required minimum distributions (RMDs). Traditional IRAs force you to take an RMD every year after you reach age 72 (or age 70½ if you reached that age before 2020), regardless of whether you actually need the money. Roth IRAs do not have RMDs at any age, so your money can stay in the account and keep growing tax-free. Finally, Roth IRAs allow you to leave a tax-free inheritance to your heirs. Recent changes in the tax code have reduced the flexibility of Roth IRAs as an estate planning vehicle by mandating that your heir distribute the funds within 10 years, but your heir will not have to pay any federal income tax on their withdrawals as long as the account has been open for at least 5 years.

The process of a Roth conversion may initially seem straightforward. First, you would need to fund a traditional IRA, either by contributing to an already existing one or establishing a new one. Then you would need to initiate the conversion by contacting your IRA administrator. This process is where the first potential pitfall emerges. You need to be sure that the conversion is handled as a trustee-to-trustee transfer, where the money goes directly from the IRA provider to the Roth IRA provider (or use the same financial institution for both your traditional IRA and Roth IRA). If you receive the money from your IRA yourself, you must be sure to deposit it in your Roth IRA within 60 days, or it will be treated as a distribution and be penalized. You must also keep any converted funds in your Roth IRA for at least 5 years. Any withdrawals of earnings made sooner will face a 10% penalty.

While the process of a Roth conversion is uncomplicated, the tax implications are anything but. The biggest factor to keep in mind is any other IRA accounts you may have and if they were funded with pre-tax dollars. Hypothetically, let us say you had $500,000 in an IRA, and this was a combination of a 401(k) rollover and other tax-deductible contributions made over the years. You then contributed $5,000 to an IRA using after-tax money, intending to convert that amount to a Roth. Well, the IRS does not allow you to make conversions on specific dollars, and instead uses a “pro-rata” rule that treats conversions proportionally across all of your IRAs. In this case, because your IRAs consist of $500,000 in tax-deferred money and $5,000 after-tax money, only 1% of your conversion will be treated as after-tax money, regardless of what account is being converted. While the benefits of a Roth IRA may mean such a conversion is still advantageous, be prepared to pay a potentially hefty tax bill when you make the conversion.

An important aspect of the pro rata rule is that it is applied at the end of the year, not the time of conversion. Suppose early in the year, you have no existing IRAs and decide to do a backdoor Roth conversion. You fund a new IRA with after-tax dollars and make the conversion, and because you only have after-tax money in your IRA, 100% is converted as after-tax money. However, if later in the year you retire and roll your 401(k) into an IRA, your new pro-rata proportion would be applied retroactively, reducing the tax-free portion of your conversion, resulting in a higher tax bill.

The bottom line is that backdoor Roth conversions can be complicated, but the extra tax benefits and flexibility in retirement and estate planning are likely worth the hoops you need to jump through. However, because the process can be so complex and fraught with unforeseen complications, it is important to work with a financial advisor and tax advisor to ensure you are maximizing the benefits and reducing potential liabilities.