The Signalert Scoop

Courtesy of Systems & Forecasts

September 15 2017

Non-Deductible IRAs and Backdoor Roth Contributions

by Dr. Marvin Appel
Signalert Asset Management

Non-Deductible IRAs and Backdoor Roth Contributions*

Key points

- **If your income is too high for you to contribute directly to a Roth IRA, you can still contribute indirectly by making a contribution to a traditional IRA without taking a tax deduction, and then converting that non-deductible IRA to a Roth.**
- **The strategy is effective if you have limited traditional IRA assets beyond the non-deductible IRA contributions you plan to make.**

In my September 1 2017 Scoop, I discussed the pros and cons of Roth versus traditional IRAs I noted that there are income limits beyond which you cannot contribute to a Roth IRA and a different set of income limits beyond which you cannot take a tax deduction for contributing to a traditional IRA. If you are fortunate enough to have income beyond these limits, there is good news: non-deductible traditional IRAs *may* offer you a back door through which you can take advantage of a Roth IRA.

The Back Door Roth IRA strategy in a nutshell

You contribute to a traditional IRA without taking any tax deduction for the contribution. Then you convert that traditional IRA to a Roth IRA. If you execute this strategy to its maximum effect, the result will be the same as if you contributed directly to a Roth IRA.

The reason why this strategy works is that since 2010 there has been no income limit on your ability to convert a traditional IRA into a Roth. In addition, there is no income limit on making contributions to a traditional IRA provided that you do not take a tax deduction for the contribution.

How does a non-deductible, traditional IRA work?

When you make a deductible contribution to a traditional IRA, you report it on form 1040 and take a tax deduction. Once that is done, you do not need to keep track of how much you contributed or how much of your current IRA balance is due to investment gains versus the amounts you contributed. When required distributions begin, every dollar is taxable as income.

When you contribute to a non-deductible, traditional IRA you report the amount on a separate form 8606 as part of your tax return. You must keep track of how much you contributed because when you start taking distributions, you will need to know how much of your IRA balance came from contributions and how much resulted from investment gains. The reason this matters is because distributions of amounts you contributed to a non-deductible IRA are not taxed, but distributions of investment returns are taxed as income. The table below compares three different IRA scenarios.

	Non-deductible, traditional IRA	**Deductible, traditional IRA**	**Roth IRA**
Contributions	No tax deduction	Tax deduction	No tax deduction
Income limits on contributions	None	Yes, if you are covered by a retirement plan at work	Yes
Tax reporting of contributions	Form 8606	Form 1040	None
Distributions	Taxable, except to the amount of basis in the IRA	All taxable	None taxable
Required distributions	Start at age 70 ½	Start at age 70 ½	None
Conversion to a Roth IRA	Amount of basis is not taxed, but accumulated investment earnings are taxed.	Income tax owed on every dollar converted	

Example of distributions from a non-deductible IRA

Suppose you contribute $5,000 to a traditional IRA without taking a tax deduction and that subsequently, that money triples to $15,000. In this case, the basis in your IRA is $5,000, which is 1/3 of the IRA. This is the amount on which you already paid income tax (before making the contribution), and is therefore not taxed again when you take it out. The remaining $10,000, 2/3 of the IRA, represents investment earnings and is taxable. As a result, 2/3 of any distribution is taxable, and 1/3 is a return of principal that is not taxable.

Non-taxable distributions reduce the remaining basis in your IRA dollar for dollar, so after each distribution you have to keep track of how much basis remains. You also have to update the calculations as to what fraction of the IRA is basis, and what fraction is untaxed investment earnings.

Avoiding taxes on non-deductible IRAs by converting to a Roth

If you examine the table above you can see that while contributions to both non-deductible and Roth IRAs are made with after-tax dollars, with a Roth IRA the investment returns are never taxed while with a non-deductible traditional IRA, investment returns are taxed. That means that if you have a choice between a Roth IRA and a non-deductible traditional IRA, the Roth IRA is superior.

The best time to convert a non-deductible traditional IRA into a Roth is immediately following each contribution, before any investment earnings have accrued. In this way, you can convert to a Roth without owing any additional taxes.

This is the backdoor Roth IRA strategy for those whose incomes are too high to contribute directly to a Roth IRA:

1. **Contribute to a non-deductible, traditional IRA**
2. **Immediately convert to a Roth IRA before any significant investment gains have accrued**
3. **No tax is owed on the amount you contributed and converted. Tax is owed only on the amount you earned between the time you contributed to the non-deductible, traditional IRA and the time you converted it to a Roth.**

One big caveat: This strategy is less effective if you have untaxed assets in other traditional IRA accounts

The IRS views all of your traditional IRA accounts as one big pool. So if you have $95,000 in a traditional IRA that was funded entirely with deductible contributions, and then you contribute $5,000 to a non-deductible IRA, the IRS treats your situation as if you own a single $100,000 IRA with a basis of $5,000. That is, your basis in your IRA is 5% of its total assets.

When you go to convert $5,000 to a Roth IRA, you do not get to selectively convert your basis. Rather, 5% of the amount you convert is not taxed and 95% is. That is hardly worth the trouble. The only way to convert the full $5,000 of basis is to convert the entire $100,000 and pay taxes on the $95,000 converted. This may or may not be desirable, depending on your situation.

If you do decide to convert all of your IRA accounts to Roth IRAs then in future years, you can execute the backdoor Roth IRA with no future impediment. It may therefore be a worthwhile strategy for younger workers to convert all of their traditional IRAs and take a tax hit up front as the price of enjoying many years of backdoor Roth IRA contributions in the future.
In order for it to be worthwhile converting your traditional to a Roth IRA, you must have the available cash outside the IRA to pay the necessary tax bill.

Retirement accounts apart from IRAs are not a problem

The good news is that traditional (ie: deductible) retirement plan contributions to 401(k) or profit sharing plans do not count as part of your IRA pool. So if you have retirement accounts through these other types of plans, you can still utilize the backdoor Roth IRA strategy. If you are planning to roll over your 401(k) plan into a traditional IRA, you might benefit by executing the backdoor Roth IRA contribution strategy before rolling your retirement plan into an IRA.

If you are the beneficiary of an inherited IRA (titled as a separate, inherited IRA) then this too does not affect your ability to use the backdoor Roth IRA strategy. Likewise, your spouse's IRAs do not affect your use of the strategy even though both may be reported on the same, joint tax return.

Conclusion

The backdoor Roth IRA strategy offers you a way to benefit from Roth IRAs even if your income exceeds the allowable limits. The only downside is that if you have significant assets in traditional IRAs that have not yet been taxed, you will have to take an initial tax hit to convert these IRAs to Roth IRAs in order to benefit from using this strategy.

Disclaimer: Signalert does not offer tax advice. We recommend that you consult with your investments, tax and/or legal advisors before acting on any recommendations in our Scoops.

Signalert
Asset Management
525 Northern Boulevard, Suite 210
Great Neck, New York 11021
516-829-6444

Since 1973, Signalert, a registered investment advisor, has specialized in risk management and preservation of capital while providing long-term growth.

For personalized investment management or financial planning, please contact us at:

Signalert Asset Management LLC
Email: clientservices@signalert.com
Web: www.signalert.com