Andrew 0:05

Hello, and welcome to the JGUA Financial Commentary Podcast. I'm your host Andrew Baron. And in this episode, I talk to senior advisor Amanda Herrick Smith about backdoor Roth strategy. But before we begin a short disclaimer, the contents of this podcast are strictly for informational purposes only, and nothing said should be taken as investment tax or legal advice. Any strategies discussed may not be suitable for listeners specifically. And JGUA encourages consulting with your advisor before implementing any strategies to ensure they meet your individual objectives. Welcome to the podcast. Amanda.

Amanda 0:45

Andrew, thank you so much for having me again, on the podcast, I really appreciate it.

Andrew 0:51

So the topic today is about Roth accounts. And I did want to describe that in a little bit more in detail. Roth accounts are a type of retirement account. And these are different than traditional retirement accounts. Because in traditional accounts contributions into these accounts are made pretax. And for Roth accounts, they are made post tax. Some listeners may have options in their 401ks that have both a traditional and a Roth option through their employer. But that's separate from what we're going to be talking about. The Roth aspect remains the same when we're talking about post tax contributions. But the accounts themselves don't really affect each other. But we're here to talk about backdoor Roth strategy specifically. So Amanda, what are backdoor Roths?

Amanda 1:40

A backdoor Roth contribution is a way in which an individual can contribute indirectly to a Roth, regardless of their income level. And the reason why they want to do this is because there are phase outs for people who contribute directly into a Roth IRA. And so for a single filing person, that income level is $140,000. So once their adjusted gross income is over these limits, they may not be eligible to contribute directly into a Roth. And for those that are filing married filing joint, that income level is $208,000. So once you're over those income levels, a way around this is to do a backdoor Roth IRA contribution.

Andrew 2:30

Amanda because this is a more advanced strategy. Could you walk us through the details on how you would do this?

Amanda 2:38

Yes, first you have to make your deposit into a Traditional IRA without taking a tax deduction. And this is also known as a nondeductible IRA contribution. Shortly thereafter, and prior to yearend, you convert the amount including any growth in your Roth IRA. It is very important that if there are any other IRAs, there likely is a component of the amount that you convert that is taxable. If there's any growth, you would pay taxes on the growth component of the amount that you convert.

Andrew 3:17

Okay. Now, why would someone want to do this?

Amanda 3:21

It's a very good question, Andrew, we understand that Roth IRAs grow tax free in their distributions in retirement are also free of tax. As we all are a little concerned with future tax rates. The Roth IRA would provide another bucket in retirement to withdraw funds from giving the retiree extra flexibility and also tax planning opportunities. Since Roth IRA withdrawals are not taxed, in a sense no required minimum distributions are required. Retirees' adjusted gross income would be lowered to help eliminate excess Medicare premiums. There's also deductions that's based on adjusted gross income. So doing a backdoor Roth contribution could be an advantage.

Andrew 4:10

Amanda, there are some tax complications that listeners should be aware of. Could you explain those?

Amanda 4:16

So there is some caution. There are pro rata rules that everyone needs to be aware of. And before you consider doing a backdoor Roth contribution, you'll first want to see if you have any traditional Sep or rollover IRAs, because the pro rata rule applies, and the pro rata rule does not include 401k in 403b plans. Since nondeductible IRA contributions create basis in the IRA, when you go to do a Roth conversion, a portion of the conversion will be taxable. So I'll explain an example.

Let's say an individual has a Traditional IRA with $14,000 of pretax contributions, this person is under age 50 and decides to contribute the maximum IRA contribution of $6,000 and not take a tax deduction, when they go to convert the 6,000, 30% of the amount converted is not taxable.

This is calculated by taking the 6000 nondeductible IRA contribution and dividing by the total IRA balance including the recent contribution. Since 30% is not taxable 70% of the $6,000 contributed is taxable, and this amount is $4,200. So, this $4,200 will be subject to marginal income tax will be included rate in your tax return. If there's a lot saved in the traditional or Sep IRAs, doing a backdoor Roth contribution may not make sense. Or if you have a 401k or 403b employer plan if it does allow for rollovers, then one way around this as you can take the SEP IRAs, Traditional IRAs or Rollover IRAs and actually transfer them into your 401k. So that way, when you go to do a backdoor Roth contribution, you don't have to pay any income taxes when you go to convert.

Andrew 6:30

What about the mega backdoor Roth strategy? Could you talk to us about that?

Amanda 6:36

So this is where you make after tax contributions into a 401k or 403b plan. It is called a mega because an IRA contribution is generally limited to $6,000 per year, or $7000 if you're over age 50. However, after tax contributions into a 401k, or 403b can be very large or mega. Since the Internal Revenue Service limits the total 401k, for example, contributions to $58,000 in this $58,000 would include the $19,500 pretax employee contributions, any employer match and also any after tax contributions. So your after tax amount could actually be pretty substantial. Doing the backdoor Roth contribution will only work for this method, if you're able to do in non-hardship in service withdrawal. So although this might not be the case, it could be a great way of building up the Roth component in your 401k or 403b. So that way, in retirement, you can actually roll over that piece into a Roth IRA and then also roll over the pretax or the traditional piece into a Traditional IRA.

Andrew 8:09

Quickly, I like to pause and explain by what you mean when you say in service rollover. Typically retirement accounts prevent current employees from being able to move their money out of the account. However, some plans allow for money to be transferred from the employer plan to another plan like an IRA, while the employee is still working. Typically, there are things like age restrictions, such as requiring the employee to be over age 55, 59 or, sometimes you'll see length of employment restrictions, meaning you will have had to have been there for two or three years. I just wanted to add that quickly, go on.

Amanda

Yes. So there is a five year rule that you'll need to understand. So with any Roth contributions, you can always withdraw what you contribute at any time for a direct Roth IRA contribution. So that's for those people who can actually contribute directly into their Roth IRAs. And they're under the income limits.

If you're under age 59 and a half, if the withdrawal exceeds what you contributed. This excess, which I like to call growth may be subject to tax and a 10% penalty. Now, if you're over 59 and a half and the account is open for less than five years. The growth is subject to tax. However, there's no penalty. Each conversion is separately subject to this five year rule. And the reason for this is to prevent people from using Roth conversions to get penalty free access to their Traditional IRA.

If doing a mega backdoor Roth contribution makes sense, the after tax contributions rolled over, are able to be withdrawn without tax or penalty. However, if the growth is converted to a Roth IRA, it is locked up for five years. So before I make any recommendations to my clients for doing a backdoor Roth contribution, I definitely make sure that they don't have any other Traditional or SEP or Rollover IRAs. And one way I do this is I work with them in putting together a balance sheet, which lists all their assets and liabilities.

And it helps me identify what type of accounts they have, and also the titling if they're in their name, their spouses name, joint name, and so forth to see if it makes sense to do a backdoor Roth contribution. And another thing that's important to look at is tax rates, what are future tax rates going to look like? Does it make sense to contribute to your Traditional IRA directly and take a deduction if you're eligible? Or does it make sense to do a Roth conversion to build that other bucket in retirement that you can draw from without having to pay any income taxes? So it's so important to work with a financial planner, or you know, a tax person, if a person that has a lot of knowledge on income taxes. To help lead you down the path. What makes the most sense for you taking a step back?

Andrew

Do you have anything to say about in general Roth conversions?

Amanda 11:33

I do, Andrew, actually, one of the things that I've been working a lot with my clients is doing Roth conversions. So one of the largest concerns is what future tax rates might look like, will they be higher. And that's a big concern of a lot of my clients. So I work with them on doing Roth conversions, which is similar to a backdoor Roth contribution because of the conversion is part of it.

But how it's different is you would take part of your Traditional, SEP or Rollover IRA in converted into a Roth. And when you go to do that, you pay tax on the amount that you convert it. But if there's no basis, because with the Roth, a backdoor Roth contribution, that creates basis in the IRA. So let's say my client decides, and I actually had this this exact case, where they wanted to do a Roth conversion of $10,000. So when they go to do the conversion, $10,000 would be subject to income tax would be included right on their tax return subject to marginal tax rates, the tax brackets we're all familiar with, just like wage income is taxed. And the reason why they might want to do that is Roth IRAs are not subject to required minimum distributions. So the amount that they convert to a Roth, they won't have to worry about doing requirement of distributions. Also, it helps build another bucket in retirement for them. So they can pick and choose where to do their withdrawals, because maybe they want to try to have their Adjusted Gross Income lower. One example is the Medicare access premium, which is based on your adjusted gross income. And another one of my clients actually did the Roth conversion to leave those assets for her grandchildren. So sometimes it can be used as an estate planning tool as well.

Andrew 13:33

Amanda, thank you so much for being part of us.

Amanda 13:35

Well, thanks so much for having me, Andrew. I really appreciate it.

Andrew 13:39

And thank you to all of our listeners. We went through quite a bit of information on this. So for our listeners, if you have a question, please email info@jgua.com and find us on social media or visit our website for additional content. Until next time, stay smart.