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Tax Notes

Tax-Free Retirement Income?

Look Behind the Curtain for the Backdoor IRA

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Many of us are looking for ways to keep more of what we make and minimize our tax burden. One effective strategy for individual taxpayers can be the Backdoor Roth IRA.

Individuals who might otherwise choose to contribute to a Roth IRA each year often find their incomes are too high to be eligible.

For 2020, you are ineligible to contribute to a Roth IRA once your modified adjusted gross income reaches $139,000 for a single or head of household filer, or $206,000 for a married couple filing jointly, and only $10,000 for those married but filing separately. These thresholds increase slightly for 2021.

As a reminder, all types of IRA contributions can be made up to the due date for filing your return, not including extensions (i.e., April 15, 2021 for 2020 contributions). The Roth IRA, unlike a traditional IRA, provides completely tax and penalty free income upon withdrawal, providing you've reached the age of 59½ and have had the money in the Roth for at least 5 years.

Roth IRAs are not subject to minimum annual withdrawal requirements as we have with traditional IRAs. (See New Rules below for distributions from inherited Roth IRAs.)

Stepping Through the Backdoor

What can you do when you find that your income is too high for the Roth IRA? A two-step technique known as the Backdoor Roth IRA provides a workaround to the problem.

Here's how it works:

Step 1

Make a non-deductible contribution to a traditional IRA account by April 15, 2021.
As long as you have sufficient earned income (Wages or Self-Employment Income), the maximum allowable annual contributions are $6,000, plus an additional $1,000 for anyone who is over the age of 50 as of December 31, 2020.

You can make a non-deductible IRA contribution even if you have maxed out your 401(k) contributions at work.

Be sure your tax preparer knows you are making a NON-DEDUCTIBLE IRA contribution so he/she can complete Form 8606 to track your "basis" in your IRAs.

Step 2

Shortly after completing Step 1, notify your financial advisor to initiate an IRA conversion by simply moving the funds from your traditional IRA account to your Roth IRA account.

Since the contribution to the traditional IRA was not deductible, the conversion to the Roth will likely be non-taxable.

If you have made any investment earnings during the time the money sat in the traditional NON-DEDUCTIBLE IRA, you may end up with a small amount of taxable income as a result, but by completing Step 2 quickly, this should not amount to very much.

Considerations

This technique works very well for individuals who do not have existing traditional IRA accounts.

For those who do, there are allocation rules that will minimize the effectiveness of the Backdoor Roth IRA and will likely result in more taxable income at Step 2.

The allocation rules require you to recognize some portion of the converted IRA in the year of conversion. But there's a workaround to that problem as well.

If your employer-sponsored plan allows you to roll your existing traditional IRA accounts into your employer's 401(k) or 403(b) plans at work, you may be able to avoid the allocation rules. There is no tax to be paid on a rollover transaction.

Using the Backdoor Roth strategy consistently year-after-year can help to build up your Roth IRA and provide you with a significant amount of tax-free income after you've reached those golden years.

New Rules

One item of caution with ROTH IRAs. As a result of the SECURE ACT effective for 2020 and beyond, there are new rules for retirement account distributions.

Generally, all IRAs inherited by NON-SPOUSE beneficiaries after December 31, 2020 must be withdrawn by the beneficiary within 10 years. They remain non–taxable during the 10-year period of withdrawal.

See our prior Thought Leadership article for further explanation of the SECURE Act.

Contact Us

For questions about a Backdoor IRA, contact your PKF O'Connor Davies tax professionals or:

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