# Money Matters

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## Skloff Financial Group Question of the Month: Backdoor Roth IRA

**By Aaron Skloff, AIF, CFA, MBA**

**Q: It seems the IRS prevents some people from contributing to a Roth IRA. Is this true and is there a workaround?**

**A: The Problem - Taxes, Taxes and More Taxes. The federal and state tax systems are built on layers of taxes. There are federal taxes on income, Medicare, Social Security, capital gains, net investment income and even estate taxes. There are state taxes on income, capital gains, dividends and even estate taxes. To make matters worse, if you invest what remains after all those taxes you pay additional taxes on your gains and interest from those investments.**

**The Solution – The Roth IRA.** A Roth Individual Retirement Account (IRA) is a tax advantaged retirement vehicle. Contributions to a Roth IRA grow tax free. That means no federal or state income taxes, capital gains taxes, net investment income taxes, etc. Roth IRA owners are exempt from required minimum distribution (RMDs). **Withdrawals by owners and those who inherit Roth IRAs are tax free.** As long as you or your spouse has earned income (primarily wages) you can each contribute up to $5,500 per person per year. If you are 50 years of age or older, you can each contribute $6,500 per year. Contributions are limited to your combined earned income.

**As is almost always the case with IRS, there is a catch.** Contributions to a Roth IRA are limited by your adjusted gross income (AGI). AGI is income after 'adjusting' for half of your self-employment taxes, alimony payments made to a former spouse and contributions to certain retirement accounts (i.e.: 401(k), 403(b), 457(b), Traditional IRA, SEP IRA, SIMPLE IRA, etc.).

If you file your tax return as single, head of household, or married filing separately your AGI must be less than $116,000 ($117,000 in 2016) to contribute the maximum amount to a Roth IRA. Maximum contributions phase out if your income is between $116,000 and $131,000 ($117,000 and $132,000 in 2016).
If you file your tax return as married filing joint or as a qualifying widow(er) your AGI must be less than $183,000 ($184,000 in 2016) to contribute the maximum amount to a Roth IRA. Maximum contributions phase out if your income is between $183,000 and $193,000 ($184,000 and $194,000 in 2016).

**Backdoor Roth IRA.** As long as you or your spouse has earned income (primarily wages) you can each contribute up to $5,500 per person, per year to a Traditional IRA as long as you are 70.5 years of age or younger by the year. After making your contribution you can then convert your Traditional IRA to a Roth IRA. **Upon converting your Traditional IRA to a Roth IRA, you create a 'Backdoor' Roth IRA.** Note: Prior to 2010, tax laws placed limitations on higher earners from completing Roth IRA conversions. Due to a change in the tax law, you can convert a Traditional IRA to a Roth IRA – regardless of your income.

**Backdoor Roth IRA Example.** On December 1, 2015, you and your spouse (both 50 years old) will be ineligible to contribute to a pre-tax Traditional IRAs or a Roth IRAs. So, you each contribute $6,500 to a Traditional IRA on a post-tax basis. On December 2, 2015 you each convert your post-tax Traditional IRAs to Roth IRAs – resulting in two 'Backdoor' Roth IRAs. Since the converted amounts are identical to your contributions the conversion is a tax free event.

**Backdoor Roth IRA with Pre-Tax Traditional IRAs, Partial Conversion Example.** This time, we add the wrinkle of owning pre-tax Traditional IRAs. If you own pre-tax Traditional IRAs, a portion of the conversion will be taxable and a portion will be tax free. Let's say you and your spouse each own a $3,500 pre-tax Traditional IRA and on December 1, 2015, you each contribute $6,500 to a Traditional IRA on a post-tax basis. On December 2, 2015, you each convert your post-tax Traditional IRAs to Roth IRAs – resulting in two 'Backdoor' Roth IRAs. Since 65% [ $6,500 / ($3,500 + $6,500) ] of the value of all of your Traditional IRAs is after-tax money, only 35% of the converted amounts are subject to taxes. Based on a $6,500 conversion and a 25% tax rate, you will be subject to $568.75 in taxes per conversion. Note: IRS Form 8606 allows you to track your after-tax contributions to avoid duplicative taxes.

**Backdoor Roth IRA with Pre-Tax Traditional IRAs, Full Conversion Example.** (Instead) on December 2, 2015, you each convert your pre-tax Traditional IRAs **and** post-tax Traditional IRAs to Roth IRAs – resulting in two 'Backdoor' Roth IRAs. Since 65% [ $6,500 / ($3,500 + $6,500) ] of the value of all of your Traditional IRAs is after-tax money, only 35% of the converted amounts are subject to taxes. Based on a $10,000 conversion and a 25% tax rate, you will be subject to $875.00 in taxes per conversion.

**Action Step – Understand Your Options**
Work closely with your Registered Investment Adviser to evaluate your Backdoor Roth IRA conversion opportunities.

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