HCR WEALTH ADVISORS

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Tax Planning Strategies

The Roth IRA, named after the late Delaware Senator William V. Roth Jr., was established by the Taxpayer Relief Act of 1997. The first accounts were opened in 1998. Over the last 20 years, it has become a household name in the world of financial services and one of the most popular investment vehicles. A Roth IRA account currently allows investors to contribute after-tax dollars up to the IRS contribution limit for that given year (in 2021, it is $6,000 for those under the age of 50 and $7,000 for those age 50 and older). The contribution of after-tax dollars gives way to one of the most powerful benefits of the Roth IRA, tax-free growth withdrawals in retirement.

However, the Roth IRA is not without issues of its own. The major drawback for the Roth IRA is the IRS restriction on who can contribute directly to them. For the tax year 2021, if you file as single and have a modified adjusted gross income (MAGI) of more than $140,000, or file as married filing jointly and have a MAGI of more than $208,000, you are restricted from making contributions directly to a Roth IRA. The work around is the "backdoor Roth IRA" strategy.

To put this strategy into practice is fairly simple. First you need to open and fund a traditional IRA. Your contributions to the traditional IRA should be made on an after-tax/non-deductible basis, meaning you will not or cannot take the tax deduction for these traditional IRA contributions. You then convert the account into the Roth IRA. This strategy is allowed because the income limits only apply to contributions directly to a Roth IRA. There are no income limits on making after-tax/non-deductible contributions to a traditional IRA.

Albeit simple, this strategy does come with a major caveat. If you have other traditional IRA assets that hold pre-tax contributions, you must abide by the IRS pro-rata conversion rules. This rule requires that all rollovers from traditional IRA's to Roth IRA's be done on a pro-rata basis. You cannot choose to only convert after-tax money. For example, if your combined traditional IRA's consist of 60% pre-tax money and 40% post tax money, 60% of your Roth conversion will be taxable.

Adam is the owner of a Traditional IRA that has a total balance of $200,000. Over the years, Adam has made a total of $30,000 of nondeductible contributions with after-tax dollars to the IRA. As a result, 15% of his Traditional IRA is made up of after-tax contributions ($30,000 ÷ $200,000 = 15%). Any distributions Adam makes from his Traditional IRA to a Roth IRA will consist of 85% taxable (pre-tax) dollars and 15% after-tax contributions. If Adam moves $20,000 from his Traditional IRA to a Roth IRA, he can't just take $20,000 of his $30,000 of after-tax contributions on a tax-free basis. Instead, $20,000 x 15% = $3,000 will be a tax-free return of his after-tax contributions, and the remaining $20,000 – $3,000 = $17,000 will be taxable. This will leave $30,000 - $3,000 = $27,000 of nondeductible contributions still inside of the IRA. Unfortunately, there is no method to take only the nondeductible contributions.

The backdoor Roth conversion strategy can be a valuable tool in getting money into a tax-free account. With the ever-increasing possibility of rates going higher, a Roth conversion could pay off in the future. That being said, the strategy is not for everyone.

As always, if you have questions about your specific situation, please do not hesitate to contact your advisor.

Sources: Forbes, Creative Planning, Motley Fool, NerdWallet, Kitces

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