Backdoor Roth: Four Tips to Maximize Tax Savings

Murray Coleman

Financial Writer - Index Fund Advisors

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At IFA, investing in a tax-efficient manner is a top priority — whether you're just starting a career or already an experienced executive. Along these lines, our IFA Taxes division works with those interested in taking a closer look at the tax implications of holding a Roth Individual Retirement Account (IRA).

While Roths are popular, many people start with a so-called traditional IRA. In this type of retirement savings account, contributions may be used to reduce your taxable income based on predetermined income limitations. With a maximum contribution limit of $6,000 in 2022 for those less than 50 years old ($7,000 for those age 50 and older), that can prove to be quite beneficial for annual tax filing purposes.

The amount contributed is also allowed by the IRS to grow on a tax-deferred basis. The trade-off is that when you go to take withdrawals during retirement from a traditional IRA, such disbursements — based on your account's growth over time — are reported as ordinary income in the year it's distributed.

By contrast, in a Roth IRA contributions do not reduce taxable income. As long as a Roth IRA has been open for five years or more and withdrawals are made after age 59.5, such withdrawals are tax-free. Contributing to a Roth essentially translates into you creating a tax-free investment vehicle through retirement.

That can prove to be a major benefit, especially for those who expect to be living at higher income levels after leaving the full-time workforce. In fact, this tax-free feature has led a lot of retirement savers to ask us whether it's possible to transfer past contributions to their traditional IRAs into a Roth account.

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Transferring traditional IRA assets to a Roth is often dubbed the "Backdoor Roth" method of building retirement savings.

In order to fully appreciate the complexities of executing such a transfer, you need to understand that both a Roth and a traditional IRA have different income limits. As a result, the viability from a tax perspective of implementing a Backdoor Roth should take into account only assets in a traditional IRA that weren't considered as deductible when contributed. "Since contributions made on a non-deductible (tax) basis haven't been subject to income tax yet," says John Dahlin, head of IFA Taxes, "these are the types of contributed traditional IRA assets that need to be the primary focus of examining any potential Backdoor Roth move."

By contrast, he finds that transferring traditional IRA assets in which contributions have already been used as deductions for annual tax filing purposes "doesn't typically turn out to be a very good idea from an individual tax savings perspective."

Sorting through all of these tax nuances can be a rather daunting task, points out Dahlin, who is a certified public accountant (CPA). At the same time, he notes the consequences of making an unwise choice in terms of tax obligations can be immense.

In fact, Dahlin has created a "must-do" checklist of key considerations for anyone thinking about implementing a Backdoor Roth strategy. According to his summary, here are four importantant steps he says you'll need to consider before making such a move:

☑ Step #1: Determine if you can contribute to a Roth IRA. If you do qualify based on the income limitations (see the table below), then it might be better to contribute directly to a Roth account than completing a Backdoor Roth transfer.

If you don't qualify, Dahlin recommends exploring a Backdoor Roth strategy. Before making any moves, however, he stresses that you need to take a close look at your estimated modified adjusted gross income (MAGI) in relation to a Roth IRA's annual income limitations.

In 2022, eligibility through such retirement savings accounts starts being phased out for individual taxpayers with MAGI of $129,000 to $144,000 in that filing year. For couples filing jointly, the MAGI restrictions kick-in from $204,000-$214,000. (See table below.)

Phaseout	Year	Single	Married Filing Jointly	Married Filing Separately	Non-Active Participant Married To Active Participant
Roth IRA phaseout	2022	$129,000-$144,000	$204,000-$214,000	$0-$10,000	No Option

Also, Dahlin suggests coming up with an estimate of your MAGI as early in the tax year as possible. "That's going to give you a clearer view of whether your income is going to be near — or at — the phaseout level," he says.

☑ Step #2: Are you considered an active participant in a qualified employer retirement savings program — such as a 401(k) and 403(b) plan — through your workplace? If so, then it's probably going to be important to consider the table below:

Phaseout	Year	Single	Married Filing Jointly	Married Filing Separately	Non-Active Participant Married To Active Participant
IRA deduction phaseout for active participants	2022	$68,700-$78,000	$109,000-$125,000	$0-$10,000	$204,000-$214,000

This tells you if a traditional IRA contribution would be deductible or not. If it isn't, then a Backdoor Roth might be advantageous from a tax perspective.

Additional Steps

☑ Step #3: If you've met the requirements in Step #1 and Step #2 — and you expect to be over the MAGI phaseout range — then it might be worthwhile to go ahead and make contributions to your traditional IRA up to the limit ($6,000 for 2022).

If over age 50, you can add a catch-up contribution, which has a limit of $1,000 in 2022.

Once those contributions are completed, Dahlin says you should make immediate arrangements to rollover the funds to your Roth IRA account. "If you leave the funds in the traditional IRA," he notes, "all income generated inside that account will be subject to being treated by the IRS as taxable income."

☑ Step #4: It's important to understand the percentage of deductible and non-deductible contributions. You need to count all contributions — regardless of the specific account. Besides your own traditional IRA, for instance, perhaps you've also got a Simplified Employee Pension (SEP) IRA account.

When you've got both types of assets (deductible and non-deductable), an IRS stipulation known as the IRA Aggregation Rule will apply. As its name implies, the rule mandates that when multiple IRA accounts exist, all of those contributed assets — in aggregate — will be counted on a pro-rata basis in determining tax consequences of taking any distributions.

For example, say you've got $100,000 in total contributions spread across (two or more) different IRA accounts. Of those contributions, let's suppose $70,000 are considered as deductible contributions and $30,000 as non-deductible IRA contributions. If you wanted to roll over $30,000 to a Roth IRA, 70% (or $21,000) of that total would be considered as taxable income for that tax year. "Don't assume you can roll over all $30,000 into a Roth IRA and expect to not wind up paying taxes," Dahlin says.

The point is, he adds: "It's not just whether it's wise to make a Roth conversion, but also how much. It's not a black-and-white question with a cookie-cutter type of answer that'll fit everyone's situation."

That's why he highly recommends that anyone thinking about such a Backdoor Roth move consult with his or her tax professional first. Dahlin, who has more than a decade worth of public accounting experience, works with both IFA clients as well as other taxpayers.

He provides free initial consultations and IFA Taxes, as a group, typically charges per project, not on an hourly basis.

You can contact him directly at: john@ifataxes.com. You can also get in touch with IFA Taxes, which is a division of Index Fund Advisors, by calling us at: 888-643-3133.

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