Reprinted from the
*Lexington Minuteman*

COROMANDEL WEALTH MANAGEMENT

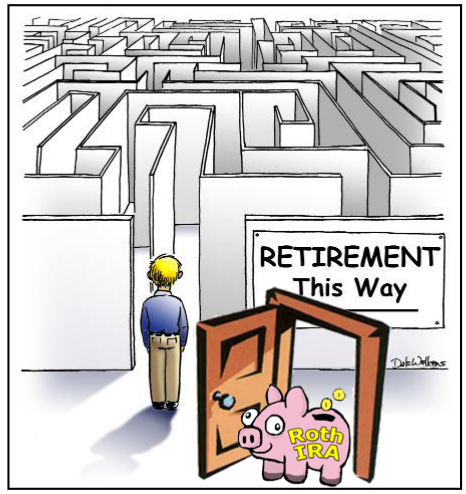
June 2015

# Don’t miss this new "Backdoor” Roth IRA

*“We often get in quicker by the back door than by the front."*

*– Napoleon Bonaparte, French General and Emperor (1769-1821)*

***Navigating the Retirement Maze***




Ever since its creation as part of the Taxpayer Relief Act of 1997, the Roth IRA has been recognized as an excellent retirement savings vehicle. By investing after-tax dollars, eventual withdrawals of investment earnings are not taxed provided that the account owner is at least 59 ½ and the account has been open at least five years. Other advantages include no required minimum distributions after age 70 ½ and the ability to recharacterize (i.e., undo) Roths.

Up until recently, there have been only two ways to fund a Roth IRA: a direct contribution or a conversion of traditional IRA assets. The former approach isn’t possible if your income exceeds certain levels – modified adjusted gross income (MAGI) of $131,000 for singles and $193,000 for married couples – and even if you qualify, the annual contribution is capped at $5,500 per year ($6,500 for 50 and over). The latter method entails an increase in reported income by the amount of the conversion, which can have significant tax consequences depending upon your income level. As I discussed in a previous article, the simplest justification for funding a Roth is if your current tax rate is lower than what you expect it to be when you eventually withdraw the funds.

## The “backdoor” Roth

Another approach to funding a Roth is known as a “backdoor” Roth conversion. This is where after-tax contributions up to the $5,500/$6,500 limits are made to a traditional IRA, and then converted from that IRA into a Roth IRA. Because the contributions are after-tax, no tax is due on the conversion of these funds into a Roth. Unlike a Roth IRA, after-tax contributions to a traditional IRA can be made regardless of income level.

Unfortunately, this approach isn’t very effective if you already have existing IRAs funded mostly with pre-tax contributions. This is because when withdrawals are taken from traditional IRAs, the portion treated as tax-free is the percentage of contributions in all of your IRA accounts that were made after-tax, also referred to as “pro rata” distributions. 401(k) and 403(b) plan balances aren’t included in this calculation, but any of these plans that were rolled over into Rollover IRAs are. So if after tabulating all of your IRA contributions it turns out that 80 percent of them were pre-tax, you would count 80 percent of the IRA funds that are converted into a Roth IRA as income. Not as bad as being taxed on the full conversion amount, but certainly not painless.

However, because of recent tax law clarifications, combined with existing rules on 401(k)/403(b) plan contributions, there is now a new way to fund your Roth that gets around this pro rata issue, and thus allows a full 100 percent tax-free Roth IRA conversion of after-tax contributions.

## A new "backdoor" Roth

A little known fact about 401(k)/403(b) plans is that while the pre-tax contributions to the plans are capped at $18,000 ($24,000 for 50 and over) in 2015, the "overall limit" for these plans – which includes employer contributions, and pre- and after-tax employee contributions – is $53,000 for 2015, plus an additional $6,000 for those 50 and over. So as long as your 401(k)/403(b) plan permits after-tax contributions, you can max out your total retirement plan contributions by adding an after-tax amount such that the total equals $53,000/$59,000 or 100 percent of your income, whichever is lower.

For example, let's say you're 56 years old with an annual salary of $140,000. You plan to contribute the maximum $24,000 to your 401(k) plan this year. Your employer kicks in another $5,000 in employer match contributions. Thus, you could still add another $30,000 in after-tax contributions to the plan.

Note the caveats here: your employer's plan must allow after-tax contributions and also include a Roth component. You can find this out by requesting a copy of your company's Summary Plan Description.

## The clincher

Eventually, through either retirement or job change, you will leave your current employer. Up until last September, if you decided to roll over your 401(k)/403(b), it came out as one lump sum and went into a Rollover IRA plan, where it was then subject to the IRA's pro rata withdrawal rules. However, last year the IRS ruled that rollovers could be split into two separate parts: a pre-tax portion (for your IRA) and an after-tax portion (for your Roth IRA). Your plan custodian issues you two separate checks, one for each account. No pro rata rules here, and no tax bill for the Roth rollover. The net result is an increase to your Roth IRA account without an accompanying tax hit.

Of course, whether you can do this is a function of how your company has its 401(k) or 403(b) plans set up. If yours permits it, it is an excellent way to fund the "tax-free" bucket of your retirement assets. If not, then maybe you should be lobbying for some changes to your company plan.

*George Gagliardi is a fee-only financial advisor with Coromandel Wealth Management in Lexington, where he helps clients develop and implement investment and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor.* *This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should only be given after an individual situation has been reviewed.*