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Time for a 'Backdoor' IRA?

Uncertainty over the fate of the looming 3.8% tax on investment income is fueling new focus on a trusted tax maneuver: the "backdoor" Roth individual retirement account.

The move allows people to transfer money from taxable accounts to a Roth IRA, which earns tax-free income.

Some eligible taxpayers who act before April 17 can put up to $12,000 per individual, or $24,000 per couple, into such accounts—by making contributions for both the 2011 and 2012 tax years.

"We're recommending them to all our clients, especially with this tax pending," says Brian Kohute, a CPA and planner at HJ Wealth Management in Plymouth Meeting, Pa. "It's almost a "no-brainer," he says, because you don't have to take a big one-time tax hit to get assets into a tax-free account.

The 3.8% tax, set to take effect in 2013, was enacted to help finance the 2010 health-care overhaul. It is an extra levy on most joint filers reporting more than $250,000 of adjusted gross income ($200,000 for singles) that applies to investment income from capital gains, dividends and rents, among other sources. But it doesn't apply to municipal-bond income and qualified payouts from Roth IRA accounts.

The Supreme Court last month heard arguments on the constitutionality of the 2010 health-care overhaul. It is expected to rule in June.

The 3.8% tax, along with scheduled tax increases in 2013, make Roth IRAs the "gold standard" now, experts say. Unlike with regular IRAs, the payouts from Roths are usually free of federal tax. Withdrawals don't trigger higher Medicare premiums or taxes on Social Security payments, and there aren't mandatory withdrawals at age 70½.

Roth IRAs can be hard to get, however. There are income phase-outs for direct contributions to a Roth account: $169,000 for joint filers in 2011 ($173,000 in 2012) and $107,000 for single filers ($110,000 in 2012). Taxpayers also can convert regular IRAs to Roth IRAs, but the transfer is of-

ten fully taxable. Many are reluctant to write that check, fearing lawmakers will rescind the Roth benefits.

That is where backdoor Roth IRAs come in. Taxpayers stymied by income limits are still allowed put up to $5,000 a year ($6,000 for those 50 and older) in a “nondeductible” IRA, as long as they are younger than 70½ and have earned income at least equal to the contribution.

There isn’t a tax deduction for the contribution, but the law allows owners to convert such accounts to Roth IRAs. IRA expert Ed Slott says there isn’t an official waiting period; he suggests a couple of weeks.

Tax is due only on the earnings in the nondeductible IRA between setup and conversion. Donna Skeels Cygan, a planner at Sage Future Financial in Albuquerque, N.M., suggests keeping assets in a money-market fund in the interim.

There is a big caveat: Backdoor Roths don’t work well for people who also have large traditional IRAs, say from rolling over a 401(k) plan. That is because taxpayers can’t cherry-pick one account for conversion. Instead they must lump all IRAs together and prorate the amount converted.

The result can be a large tax bill. For example: You have $95,000 in a regular IRA and $5,000 in a nondeductible IRA. If you convert $5,000 to a Roth IRA, then 95% of the converted amount, or $4,750, is taxable because it is deemed to be from the regular IRA—no matter which account it is from.

To avoid the proration problem, Natalie Briaud Pine, a planner in College Station, Texas, suggests taxpayers roll regular IRAs their 401(k) plans, leaving only the nondeductible IRA to be converted. Such transfers aren’t taxable. This works if the plan allows rollovers—as many do—and investment choices and fees are reasonable. Remember: It is harder to get money out of a 401(k) in an emergency.

Ms. Cygan is reminding clients who don’t already have a backdoor Roth that they can make two contributions this year—one for 2011 (until April 17) and one for 2012: “Just write two checks, and note that one is for each year.”

What if a taxpayer needs money from a Roth account? Withdrawals from backdoor Roths within five years of conversion are usually subject to a 10% penalty unless the owner is 59½ or older. Each conversion carries a five-year limit.

The Internal Revenue Service hasn’t raised any red flags on backdoor Roths that are properly reported on form 8606. According to a spokesman: “The law is pretty clear on this issue.”

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