Backdoor Roth IRA Explained: How High Earners Can Still Build Roth Savings

Nate: Okay, so the, the concept of a backdoor Roth conversion is new to some people. It has existed for a while. Andy, you want to take a high-level approach at kind of just the overall mechanism of how, how and when it works?

Andy: Yeah. So this has been around for a long time, but the gist of it is that there's a income phase out to be able to make a Roth IRA contribution directly, okay? And a lot of people fall into that phase out. A lot of people make too many to, make too much money to directly make a Roth IRA conversion. So the reason it's called a back door is that the mechanism is you first make a traditional IRA contribution. We always say, wait a couple days and then go ahead and convert that traditional IRA contribution to a Roth IRA and I know a lot of you're like, Well, why can't I just make a direct Roth IRA contribution? It's because the rule says you can't and, but if you do it traditional first couple days later, convert it to Roth, with some other sometimes unknown rules, it can work. And for some people, it's worked for many, many, many years.

Nate: Yeah, and you know, you touched on it there being, waiting a couple days. And you want that timeline to be relatively short, right? Because when you convert this, what you don't want is a whole bunch of earnings, right, that are now going to be taxable. And you probably weren't planning on it. So for many folks, that puts them in an disadvantageous position when they come to file, because of course, all of this is going to be on a government form, and it'll probably be somewhere in the mass amounts of emails you receive from your retirement services platform. But it's not necessarily going to be exactly known until that point, but really what it serves is, like you said, a way to convert assets to be Roth based, and it works because you didn't get to take a tax deduction for that contribution to your traditional IRA. Creates what's called basis and protects the distribution and rollover. So that is something that has been a powerful tool for many, especially with kind of building their buckets on both sides of the traditional and and Roth aspect of retirement assets.

Andy: Without getting too technical, I'll tackle one of the misnomers, though. The key is, is that when you make that traditional IRA contribution and convert it to Roth. Ideally, when you do the conversion, that zeros out your balance in any traditional IRA, because if you have an existing balance, then that conversion won't be completely tax free. It will be a pro-rated taxable event.

Nate: That's right. The IRS has this rule that says, if you are taking a distribution, they treat it, and you have more than one account, or you have a balance left in that account, they treat it as partially coming from your tax sheltered contribution and partially from your non-tax sheltered contribution. So that could be across other IRA accounts, that could be within the same IRA account that maybe you started early in your career, and we're getting tax deductions for a number of years, contributing to it, can be an annoying surprise come filing time. If it's not something you're aware of. Go ahead.

Andy: At the same time, it can be a great planning point. We have a lot of clients approach us that say, Hey, I'd like to start doing the backdoor Roth, okay, what's our first question? Do you already have an existing IRA account balance? And they may say, Yes, I haven't, like you said, an old IRA maybe, let's say a $30,000 balance, $50,000 balance. And as long as they can go back and see what their original contributions were, did they get a tax deduction or not? A lot of times, it can make sense to bite the bullet, convert that entire balance over, pay some tax, and now you've cleaned the slate, and if you have a long-time horizon to make contributions going forward and do the backdoor Roth? Long career ahead of you? It can make sense to open the door to that future of multiple years of the backdoor Roth.

Nate: That's right, and especially if you're looking at doing this earlier in the year, might be ideal timing, because then you've got the rest of the year to maybe pull some of your other tax levers and manage your income, and if it's going to be taxed, at least, maybe you can get it into some lower brackets, and that way it doesn't stink quite as much and you don't have as much to replenish. But there is another alternative that will help some folks, and that is if you have a, are participant in a company plan, because there are commonly company plans, if they allow for it, many of them allow roll-ins of outside retirement accounts. And as long as you're keeping your pretax or traditional IRA funds as pretax into your company balance, those can remain untaxable. So you can do what's called the reverse roll-in to the comp, your balance of your company 401K plan, and possibly wipe out that IRA balance to begin doing, back to our Roth conversions sooner than later, which can be really powerful and save a ton of tax.

Andy: Yeah, totally agree. And I think the other thing to consider with Roth conversions, okay. The concept is, I have money in a traditional IRA, and I want to get, I want to diversify my portfolio, and I want to, I want to convert money to Roth. What I said earlier is if, if that balance is too large to do it while you are still in the prime of your career, or you're in the high earnings years of your career, a lot of clients will then wait until they're in lower earnings years. Either you have a gap, you know, you sell a practice, you take a sabbatical, something happens where you have a few years of lower income, or you get to retirement. It can make a lot of sense in those lower income years to be taking advantage of lower tax brackets, converting a portion of your traditional IRA to Roth, and then having that Roth balance grow for years to come, and then potentially be assets that are passed on to, to future generations.

Nate: Exactly. So there's a number of ways, if you have traditional IRA balances, that your income is such that you're, you're not getting any tax benefit from contributing to those accounts anymore. You'd like to look at doing some, some of your assets to, to Roth for you know, there's great amount of benefits in terms of how the earnings are treated, the the post tax aspect of when you withdraw later that that is not going to be taxed at whatever tax rates might be in the future. And those timelines are different for everybody. But you've got a few solutions for how to manage that situation and get to the point where you can make those contributions. So it is absolutely a discussion to start having with your wealth advisor, if you have one, with your CPA, and because you're more than likely, you're going to need both of those folks at the table, because your retirement person is not going to give you tax advice and your CPA is not going to give you retirement advice on how your assets, how and where your assets should be placed.

Andy: Yeah. And the bottom line for me is start by getting your ducks in a row. There, a lot of people don't realize they have an old Roth account here or IRA account. Just line up and get get a statement for all of your accounts. Know where your money is and what form it's in. Find out, have I been doing the backdoor Roth? Have I been doing it right? Do I know what a backdoor Roth is? And once you know where your money is, what you've been doing, what the opportunity is for you, have the conversation, depending on what stage you are in your career, and see what's most advantageous to you right now.

Nate: Exactly. And one of those proverbial ducks might be also reaching out to your company plan administrator or your HR person to ask the question, hey, does our plan allow roll ins from outside retirement accounts? Because that can really impact the decision of, okay, do I do this now? Do this later. How much do I do now? And can help you come into the discussion with your advisors, educated and providing some options for them to think about.