

Here's a backdoor way to establish a Roth IRA

Most prognosticators are convinced that income tax rates will eventually rise in an attempt to offset accelerating government debt. Given this assumption, many people would like to pay taxes on their retirement savings at today's rates. The way to do this is by contributing to a Roth IRA or Roth 401k. There is no tax deduction for the initial contribution, but all growth in the account over time is tax free upon withdrawal in retirement.

But many people who are concerned with being tax efficient with their investments are ineligible to contribute directly to a Roth IRA because of income limits. Eligibility to contribute directly to a Roth IRA begins to phase out at \$169,000 of modified adjusted gross income for married couples filing jointly and \$107,000 for single filers in 2011.



Gary Brooks

In reality, however, if you're willing to deal with some extra paperwork, there is no income limit to participate in a Roth. That is because the government has provided an open backdoor that allows anyone to invest in a Roth.

Here's how to do it if your income exceeds direct contribution limits:

- Make a nondeductible contribution to a traditional IRA (up to \$6,000 per year if you're over 50, \$5,000 per year if you're under 50).
- Open a Roth Conversion IRA and transfer the nondeductible contribution in the traditional IRA to the

Roth IRA. There is no income limit to Roth conversions in 2011. There would be no tax due on the original contribution. If the account grew in value between when the nondeductible contribution to the traditional IRA was made and when this money was moved to the Roth, ordinary income tax will be due on the growth. But if you open the traditional IRA, leave the contribution in cash and immediately transfer it to the Roth Conversion IRA, there's no tax.

Since we're still several weeks from the income tax filing deadline, you can still make a nondeductible contribution for 2010 as well as the 2011 contribution. This would allow for up to a \$12,000 tax-free conversion to a Roth IRA (if you're over 50).

This could be helpful if you have maxed your employer retirement plan contributions and would still like to position more dollars for retirement savings during your peak earnings years.

The Roth IRA also would provide an open investment platform to invest in asset classes, specific funds or stocks that may not be available in your employer retirement plan.

Ultimately, the tax-free nature of future growth is the biggest benefit. This is especially beneficial if you do not expect to need the assets to fund retirement and will pass them on to a next-generation beneficiary. The tax-free compounding for yet another generation makes a big difference in the amount of money that ultimately could be distributed from the account.

There is one complication that is important to understand. If you have a traditional IRA or multiple IRAs that are composed of both nondeductible contributions and regular tax-deductible contributions, you cannot convert just the nondeductible contributions to a Roth IRA and leave the tax-deductible contributions in the traditional IRA.

This applies even if you've separated nondeductible contributions into a different account than the deductible contributions. The IRS considers all traditional IRAs as one when it comes to distributions or Roth conversions. Traditional IRA balances are aggregated such that upon conversion to a Roth IRA, the amount converted becomes a prorated mix of taxable and nontaxable dollars. You would owe ordinary income tax on some of the amount converted.

If you're not sure whether your previous contributions to a traditional IRA were deductible or not, IRS Form 8606, filed along with your past income tax returns, will demonstrate the amount of nondeductible contributions (nontaxable basis).

This backdoor to a Roth is unfortunately limited to just the \$5,000 or \$6,000 annual contribution limits of IRAs. But it may provide some tax diversification to your investments. And now is the time to do it. Don't be surprised if this opportunity expires in 2013, when tax rates are scheduled to change.

Gary Brooks is a certified financial planner and the president of Brooks, Hughes & Jones in Old Town Tacoma. Reach him at gary@bhjadvisors.com.