insight

https://www.icpas.org/information/copy-desk/insight/article/digital-exclusive---2024/roth-ira-conversion-is-it-right-for-high-earners

Roth IRA Conversion: Is It Right for High Earners?

Backdoor Roth IRA conversions have become a must-consider retirement and estate planning strategy.

By Daniel F. Rahill, CPA/PFS, JD, LL.M., CGMA | Illinois CPA Society Digital Exclusive – 2024

Since inception, Roth individual retirement accounts (IRAs) have allowed taxpayers to establish tax-advantaged retirement accounts either through direct contributions or by converting their traditional IRAs into Roth IRAs, a process referred to as a Roth conversion. Initially, these options were both unavailable to higher-income individuals, as eligibility for direct Roth IRA contributions and Roth conversions was limited by a taxpayer's modified adjusted gross income (MAGI).

Though this happened some time ago now, the Tax Increase Prevention and Reconciliation Act of 2005 repealed the MAGI limitations for Roth conversions, effective for tax years beginning after 2009. As a result, Roth conversions became—and still currently are—accessible to all taxpayers, regardless of income level. Naturally, this has increased the appeal and popularity of Roth conversations and has established them as a staple in any financial plan.

I believe the importance of considering a Roth conversion is even greater in the wake of the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019. This act requires most non-spousal inherited IRAs to be distributed entirely within 10 years, replacing the previous rule allowing distributions over the beneficiary's lifetime. This change significantly enhances the attractiveness of directly funding Roth IRAs and/or pursuing a Roth conversion.

While distributions from an inherited traditional IRA result in taxable ordinary income throughout the 10-year distribution period, the investments held in a Roth IRA can grow tax-free until the end of the same 10-year period, at which point a fully tax-free distribution can be made to the beneficiary. In other words, Roth IRAs and Roth conversions are now powerful estate planning tools for retirees and their beneficiaries. This is especially true for beneficiaries with other sufficient assets to live on, allowing them to defer the inherited Roth IRA distributions for the full 10 years, maximizing the account's tax-free growth potential.

Another advantage Roth IRAs have over traditional IRAs is that Roth IRAs or Roth 401(k)s have no required minimum distribution (RMD) mandate thanks to 2022's SECURE Act 2.0. This allows Roth IRA balances to continue growing tax-free throughout one's retirement, whereas traditional IRA balances must begin being drawn down by those age 73 in 2024.

It should be noted that there's still a contribution and distribution limitation specific to Roth IRAs. For example, in 2024, single filers whose MAGI is more than $161,000, and married couples filing jointly whose MAGI exceeds $240,000, cannot make direct Roth IRA contributions. And, the five-year rule mandates that you must wait at least five years after your first Roth IRA contribution before you can withdraw any tax-free earnings. This rule applies to all Roth IRAs, including inherited and converted accounts.

The Backdoor Roth

For the seemingly ineligible, the backdoor Roth conversion is a strategy used by taxpayers whose incomes exceed the limits to contribute directly to a Roth IRA.

Executing the backdoor Roth strategy involves two steps:

1. **Make a nondeductible contribution to a traditional IRA:** This nondeductible contribution has no income limits, but there's a contribution limit. In 2024, individuals under 50 can contribute up to $7,000, while those 50 and older can contribute up to $8,000.
2. **Convert the funds from the traditional IRA to a Roth IRA:** Since taxes have already been paid on the funds used for the nondeductible contribution, this conversion typically incurs little to no additional tax liability, depending on whether there are any earnings on the funds between the time of contribution and conversion. To minimize any earnings, and thus minimize taxes, the conversion is usually completed promptly after the nondeductible contribution is made.

A significant limitation for backdoor Roth conversions, however, is the "pro-rata rule." This rule applies if there are traditional IRA assets in addition to the nondeductible IRA contribution wished to be converted.

The pro-rata rule requires that a proportional amount of both pre-tax and after-tax funds held in a traditional IRA be converted during a Roth conversion. This can result in a taxable conversion on any preexisting traditional IRA assets, reducing the tax-free benefit of the conversion.

Avoiding the pro-rata rule comes down to ensuring there are no pre-tax funds held in any traditional IRA accounts at the time of conversion. Taxpayers with pre-tax funds in traditional IRA accounts should consider converting them to a Roth IRA before executing the backdoor Roth strategy. Alternatively, if the taxpayer has access to an employer-sponsored retirement plan, like a 401(k) that allows rollovers from traditional IRAs, they should consider rolling over any pre-tax traditional IRA funds into their employer's 401(k) plan.

A Cautionary Word

Likely the most publicized Roth IRA is the one belonging to Peter Thiel, as disclosed in the 2021 ProPublica article, "Lord of the Roths: How Tech Mogul Peter Thiel Turned a Retirement Account for the Middle Class Into a $5 Billion Tax-Free Piggy Bank." In 1999, Thiel, a co-founder of PayPal, had an income of $73,263 (below that year's Roth income threshold of $110,000). He contributed $2,000 to a Roth IRA, which was used to purchase PayPal shares. By 2003, when PayPal was sold to eBay, those PayPal shares were worth $28.5 million. By 2019, ProPublica reported that Thiel's Roth IRA had grown to approximately $5 billion.

In reaction to the ProPublica article, the House Ways and Means Committee drafted proposed legislation in 2022 to limit wealthy individuals' participation in tax-advantaged retirement accounts. Roth strategies, such as the backdoor Roth conversion highlighted here, would've been limited or eliminated. Although this proposed legislation never became law, it serves as a warning that these strategies could be modified or eliminated in the future. In other words, act now if you can.

For high-income earners who exceed the limits for direct Roth IRA contributions, the Roth conversion and backdoor Roth strategies are effective retirement and estate planning techniques to consider now. These strategies are ideal for investors expecting higher taxes in retirement or those wanting to leave tax-free inheritances to their beneficiaries. However, as the Peter Thiel case and resulting political backlash have shown, there's always a concern that future tax law changes could modify the benefits of Roth IRAs. That said, proactive retirement planning should result in significant benefits in the future for both retirees and their heirs.

Daniel F. Rahill, CPA/PFS, JD, LL.M., CGMA, is a wealth strategist at Wintrust Wealth Management. He is also a former chair of the Illinois CPA Society Board of Directors and is a current officer and board member of the American Academy of Attorney-CPAs.

Related Content:

- A Crucial Window for Estate Planning: Preparing for 2026 Changes: Exemption amounts under the Tax Cuts and Jobs Act of 2017 are set to expire, making now an essential time for individuals and families to revisit their estate plans.
- 12 Reasons a SLAT Makes Sense: Spousal lifetime access trusts can be effective and flexible solutions for married couples looking to take advantage of existing estate and gift tax laws while maintaining control of their assets.