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Avoid These Backdoor Roth IRA Pitfalls

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While the prospect of tax-free retirement income is tempting, Roth individual retirement accounts (IRAs) aren't without their detractions and can lead to unexpected costs, especially if you use a backdoor strategy.

With a backdoor Roth IRA, you avoid income restrictions placed on Roth IRAs by first making non-deductible contributions to a traditional IRA (which

anyone can do as long as they have an earned income) and then converting your traditional IRA to a Roth.

If you're otherwise locked out of a Roth IRA because your income is in the high six figures, this handy backdoor can let you reap the tax benefits of a Roth. But these conversions can get tricky—and costly. Here's what you should look for when you do a backdoor Roth IRA conversion.

Backdoor Roth IRA Pitfall #1: An Unexpected Tax Bill

The allure of the backdoor Roth IRA is the potential to complete the transaction and avoid any additional taxes you'd face in retirement if you put the money in a traditional IRA. But if you don't take into account all of your existing IRAs, you might end up with an unexpected tax bill.

Two facts to keep in mind: Non-deductible contributions are made with money that's already been taxed. And when you convert a traditional IRA to a Roth IRA, you owe a bill to Uncle Sam on any money that hasn't been taxed yet. Practically speaking, you can avoid this as long as you don't invest the money when you put it into your IRA and then you convert it to a Roth quickly.

Here's the big honking catch, though: If you have pre-tax money sitting in any other traditional IRA accounts, your backdoor Roth conversion will trigger a tax bill, courtesy of the IRS' pro-rata rule.

The Pro-Rata Rule and Backdoor Roth Conversions

For tax purposes, the IRS considers all your (seemingly separate) IRAs as one big account. The pro-rata rule boils down to the percentage of your total combined IRA balances that has yet to be taxed. Whatever that percentage is

determines the percentage of your backdoor Roth IRA conversion that will be taxed.

For example, let's say you have $94,000 in existing traditional IRAs that were funded with pre-tax dollars. And now you contribute $6,000 to a new traditional IRA with after-tax dollars, then immediately convert that $6,000 to a Roth via the backdoor Roth IRA strategy.

As far as the IRS is concerned, you now have $100,000 in traditional IRAs, and the $6,000 you are contributing with after-tax dollars represents 6% of your total. That means only $360 of your $6,000 backdoor conversion is tax-free (6% of $6,000). You owe income tax on the other $5,640 you backdoored.

Backdoor Roth IRA Pitfall #2: The 5-Year Rule

One of the big benefits of the Roth IRA is that you can withdraw your contributions from the account at any time, for any reason, without incurring penalties or taxes. There's just one limit on this feature: You have to wait five years after making your first contribution to avoid penalties when taking withdrawals from the account.

The five-year clock starts ticking on January 1 of the year you made your first contribution. If you withdraw funds before five years are up, you may owe taxes and a 10% penalty on the withdrawal.

There's an additional wrinkle with this rule when you do backdoor conversions, though. Each of your converted Roth IRAs has its own five-year clock on it. And because none of the money was taxed before, all of it, not just the earnings, is subject to taxes plus the 10% penalty if you make a withdrawal before five years is up.

"If you think there's any chance you may need the money sooner than five years, you might want to reconsider making the move," says says Brian Robinson, a certified financial planner (CFP) in Phoenix.

Backdoor Roth IRA Pitfall #3: Unintended Costs

If you're in your 60s or older, it's vital to understand that other parts of your financial life, namely your Social Security and Medicare benefits, could be impacted if you technically realize income through a Roth IRA conversion.

- **Taxation of Social Security benefits.** If you're already receiving Social Security benefits, they may be partially taxed based on your income. If the backdoor Roth IRA bumps your income higher, you may find your Social Security benefits are partially taxable or a greater portion of your benefit could become taxable.
- **Higher Medicare Part B premiums.** Nearly all Medicare enrollees pay a monthly premium for Medicare Part B, which covers doctor visits, tests and outpatient treatment. The monthly premium is based on your MAGI reported on your tax return from two years ago. In 2021, individuals who reported income below $88,000 on their 2019 return and married couples below $176,000 pay the lowest possible Part B monthly premium of $148.50. Above those thresholds, Part B premiums are higher. There are also income-based premiums for Medicare Part D that cover prescription drugs.

Pitfall #4: You Expect Your Tax Rate in Retirement To Be Lower

If you're in a high federal income tax bracket today and expect your income in retirement to be much lower, a backdoor Roth conversion that incurs a tax bill might not make sense. But Robinson cautions that even if you expect to have less income, it's worth considering that the federal government may at some point raise tax rates from their current historically low levels to help address the federal deficit.

The Final Word on Backdoor Roth IRAs: Talk to a Pro First

If you don't have any money sitting in traditional IRA accounts, a backdoor Roth is a smart way to build up retirement savings that will be tax-free in retirement. And it can still make sense if you already have a chunk of savings in traditional IRAs.

Either way, talk to a trusted tax professional or financial advisor who understands all the moving pieces first. Backdoor Roth IRAs impact your taxable income, and a professional can help you navigate the potential pitfalls of this useful strategy.