

Think You Earn Too Much Money to Contribute to a Roth IRA? Guess Again

Lawrence B. Keller, CFP®, CLU®, ChFC®, RHU®, LUTCF



Lawrence B. Keller

Although it has been around since 1998 and is one of the best financial tools available, most oncologists, as high-income taxpayers, were unable to take advantage of the Roth IRA because of income limitations. However, as

of January 1, 2010, that all changed when the income limit for Roth IRA conversions was eliminated. As a result, taxpayers earning more than \$100,000 were suddenly eligible to convert their IRAs and other eligible retirement accounts to a Roth IRA.

What Is a Roth IRA?

A Roth IRA is an individual retirement account named after the late senator William V. Roth, Jr (R-Delaware) that allows you and your spouse to make nondeductible contributions to save for retirement. However, rather than growing on a tax-deferred basis, all qualified distributions are made on an income tax-free basis.

For 2012, an individual may directly contribute the lesser of \$5000 or 100% of his or her annual compensation to a Roth IRA.

For 2013, an individual may directly contribute the lesser of \$5500 or 100% of his or her annual compensation to a Roth IRA. For a married couple, an additional \$5000 or \$5500, respectively, may be contributed on behalf of a lesser earning (or nonworking) spouse using a spousal account (Table).

In addition, if an IRA owner is

aged ≥ 50 years, he or she may contribute an additional \$1000 (or \$2000 if a spouse is also aged ≥ 50 years).

As with many tools that offer tax advantages, Congress has limited who can contribute to a Roth IRA based on income. A taxpayer can only contribute the maximum amount if his or her modified adjusted gross income (MAGI) is below a certain level. Otherwise, a phase out of allowed contributions

For 2013, an individual may directly contribute the lesser of \$5500 or 100% of his or her annual compensation to a Roth IRA. For a married couple, an additional \$5000 or \$5500, respectively, may be contributed on behalf of a lesser earning (or nonworking) spouse.

runs throughout the MAGI ranges that are shown in the Table. Once the MAGI meets or exceeds the maximum of the range, no contribution is allowed at all.

Although it is true that individuals cannot make a direct contribution to a Roth IRA if their MAGI exceeds the published limits, they can still contribute through a loophole known as the “backdoor” Roth

IRA, which effectively allows them to legally circumvent the limits and take advantage of the valuable benefits provided by a Roth IRA.

How to Contribute to a Roth IRA If Your Income Exceeds These Limits

Individuals can make a nondeductible (posttax) contribution to a traditional IRA. As soon as the contribution posts, they subsequently convert their nondeductible traditional IRA to a Roth IRA. The only additional tax that is due would be if their account increased in value from the time of the contribution until the time of the conversion. The individual would then repeat these steps year after year until the backdoor Roth IRA loophole is closed by the government and is no longer available.

A Word of Caution

If an individual has any other IRAs (including SEP-IRAs, SIMPLE IRAs, and/or rollover IRAs) that were funded with pretax dollars, the taxable portion of any conversion made is prorated over all of the IRAs. For example, if one had an IRA balance of \$100,000 and only \$5000 (5%) was funded with posttax contributions, then only 5% of any conversion would be income tax free, and the balance would be subject to ordinary income taxes.

The higher the percentage of posttax dollars (which are tracked by Form 8606, a form that is attached to one's federal income tax return) to the total value of the IRAs, the smaller the tax burden on the amount converted. Therefore, to really benefit from the backdoor Roth IRA, one must either con-

vert his or her other IRAs as well or transfer IRA contributions that were funded with pretax dollars to an employer-sponsored plan that accepts IRA rollovers so that all that remains are IRAs funded with posttax dollars.

Roth IRA Strengths

Qualified Distributions Are Completely Income Tax Free

A withdrawal from a Roth IRA (including both contributions and investment earnings) is completely income tax free and penalty free if (1) the withdrawal is made at least 5 years after a person first established any Roth IRA, and (2) if 1 of the following also applies:

- You have reached age 59.5 years by the time of the withdrawal
- The withdrawal is made as a result of a qualifying disability
- The withdrawal is made for first-time homebuyer expenses (\$10,000 lifetime limit)
- The withdrawal is made by your beneficiary or your estate after your death.

Withdrawals that meet these conditions are referred to as “qualified distributions.” If the above conditions are not met, any portion of a withdrawal that represents investment earnings will be subject to federal income tax and may also be subject to a 10% premature distribution tax if you are aged <59.5 years.

No Required Minimum Distributions Starting at Age 70.5 Years

The IRS requires you to take annual required minimum distributions from traditional IRAs beginning when you reach age 70.5 years. These withdrawals are calculated to dispose of all of the money in the traditional IRA over a given period of time. Roth IRAs are not subject to the required minimum distribution rule. In fact, you are not required to take a single dis-

Table.

Roth IRA contribution limits MAGI phase-out ranges	2012	2013
Single individuals	\$110,000-\$125,000	\$112,000-\$127,000
Married filing a joint income tax return	\$173,000-\$183,000	\$178,000-\$188,000
Married filing separate tax returns	\$0-\$10,000	\$0-\$10,000
MAGI indicates modified adjusted gross income.		

tribution from a Roth IRA during your life (although distributions are generally required after your death).

You Can Contribute to a Roth IRA after Age 70.5 Years

Unlike traditional IRAs, you can contribute to a Roth IRA for every year that you have taxable compensation, including the year in which you reach age 70.5 years and every year thereafter.

A backdoor Roth IRA might be a good option for oncologists who want to save more money for retirement and are already taking full advantage of employer-sponsored retirement plans.

No Income Taxation to Your Beneficiary on Withdrawals from Inherited Roth IRAs

As long as any Roth IRA you have established has been in existence for at least 5 years at the time of your death, your beneficiary will

not have to pay any federal income tax on postdeath distributions. Even if you have not satisfied the 5-year holding period at the time of your death, distributions to your beneficiary will still be tax free if he or she waits until the date you would have satisfied the 5-year holding period before taking the distributions. This can be a significant advantage in terms of your estate planning.

Conclusion

A backdoor Roth IRA might be a good option for oncologists who want to save more money for retirement and are already taking full advantage of employer-sponsored retirement plans. However, if you have any other IRAs, including SEP-IRAs and/or SIMPLE IRAs, that were funded with pretax dollars, the taxable portion of any conversion you make is prorated over all of your IRAs. As a result, collaboration between your financial advisor and your tax professional is essential. ●

Lawrence B. Keller, CFP®, CLU®, ChFC®, RHU®, LUTCF, is the founder of Physician Financial Services, a New York-based firm specializing in income protection and wealth accumulation strategies for physicians. He can be reached for comments or questions at 516-677-6211, or by e-mail at Lkeller@physicianfinancialservices.com.