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Using Nondeductible IRAs to Fund Roth IRAs

This is the third in a series of articles relating to estate planning with Roth IRAs. The first article addressed what Roth IRAs are and why taxpayers should consider incorporating them into their overall financial, tax and estate planning strategy. The second article described different ways to build a Roth IRA. An upcoming article will discuss using Roth IRAs as intergenerational wealth transfer vehicles.

This article addresses one narrow planning technique that many people find useful in building Roth IRAs: Forming and funding "nondeductible" IRAs and then converting those nondeductible IRAs to Roth IRAs.

Taxpayers can open nondeductible IRAs regardless of their income level. Deductible IRAs are only allowed for taxpayers with specified income levels and who do not participate in an employer sponsored retirement plan. These income levels and nonparticipation in employer sponsor retirement plans do not apply for contributions to nondeductible IRAs.

In general, a nondeductible IRA can be funded regardless of whether the taxpayer has earned income. While the annual contribution limit is $5,500, taxpayers who have attained age 55 before or during the year of the contribution may make an additional $1,000 per year "catch up" contribution. Thus, for taxpayers age 55 and over, the annual contribution limit for a nondeductible IRA is $6,500.

Contributions to nondeductible IRAs receive no special tax treatment as only after tax dollars are contributed and no deduction is allowed for the contribution. Earnings generated by nondeductible IRAs are tax deferred and will be taxed as ordinary income when withdrawn. If a taxpayer owns both deductible and nondeductible IRAs, the distributions from both accounts are prorated to determine the nontaxable and taxable portions of the distributions.

A nondeductible IRA can be converted to a Roth IRA at any time. However, to the extent the nondeductible IRA has earnings, the amount converted will trigger income tax. Also, if a taxpayer owns both deductible and nondeductible IRAs, the conversion will be deemed made pro rata from the deductible and nondeductible IRAs. Accordingly, the conversion of nondeductible IRAs could trigger significantly more taxable income than anticipated if there are also significant deductible IRAs.

The technique addressed in this article involves the funding of a nondeductible IRA with an immediate conversion to a Roth IRA before the deductible IRA has a

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chance to generate substantial income. For example, a nondeductible IRA can be formed and a $5,500 ($6,500 for taxpayers age 55 and older) contribution be made, which contribution is then immediately converted to a Roth IRA. Using this technique, the Roth IRA can be funded annually up to the nondeductible IRA's contribution limit without triggering any taxable income.

Lastly, married couples can effectively "double up" on contributions to their respective nondeductible IRAs regardless of whether either or both spouses have earned income.

If you would like to discuss this planning technique, or any other aspect of your overall financial, tax and estate planning strategy, please contact Reinhart's Trusts & Estates attorneys.