

Ready to Roth: How You Fund an IRA Conversion Through the 'Back Door'

By Kelly Greene

My wife and I have been unable to contribute to Roth IRAs for the past several years due to the Roth IRA income limits. We have Roth IRAs from years that we were eligible, and we both have rolled over 401(k)s from previous employers to IRAs. I was planning to take advantage of the back door into the Roth IRA for people like ourselves. We were going to fund after-tax, traditional IRAs for 2009 and 2010 this month, and then immediately convert them to Roth IRAs, which we had hoped would be tax-free, since all of the money converted would be after-tax money. However, I read in a Wall Street Journal article that you can't convert only your nondeductible contributions. You have to calculate your "basis" and deduct that portion.

My follow-up question is: Are my rollover IRAs from previous 401(k) plans considered part of my total balance in IRAs? Or can I only count the traditional IRAs that I'm converting as my IRA balance?

—Swastik Lahiri, Plano, Texas

Individual retirement accounts funded with 401(k) assets count among your traditional IRA assets during a Roth IRA conversion.

The language is confusing, since many custodians refer to such accounts as rollover IRAs. But they are technically traditional IRAs. Any IRA labeled as a SEP, SIMPLE or contributory is included, as well.

As you point out, you could fund traditional IRAs for 2009 and 2010 anytime between now and April 15 (and you could fund a 2010 IRA contribution up through April 15, 2011). There are no income limits for making nondeductible IRA contributions. But there are income limits for making Roth IRA contributions: Individuals whose modified adjusted gross income for 2010 is \$120,000 or more can't contribute. For couples who file joint tax returns, the cutoff is \$177,000. (You can figure out your modified adjusted gross income using a work sheet on page 59 of Publication 590 at www.irs.gov.)

Here is where the "back-door" method comes into play: As of Jan. 1, the federal government has lifted the \$100,000 household income limit (again, modified adjusted gross income) on converting traditional IRA assets to a Roth. Having that limit removed makes it possible for people with higher incomes to move assets from traditional IRAs to Roth IRAs. First, you would fund a traditional IRA and then you could convert those assets to a Roth.

But people, including our readers here, who have rollover IRAs from past employment will have to include those assets when they figure out how much tax they owe on such a conversion. You can convert all, or part of, your traditional IRA assets to a Roth, but you owe tax proportionately on the amount that wasn't taxed previously.

That is where the Internal Revenue Service's pro rata rule comes into play. Basically, you can't cherry-pick the assets you convert. Instead, the IRS says you must first take the balance in your IRA, or the combined balances of multiple IRAs, and then divide any nondeductible contributions by that balance. This gives you the percentage of any conversion that is tax-free.

Let's say your rollover IRA has a balance of \$23,000, and the new IRAs you fund are worth \$13,000, including \$12,000 in nondeductible contributions. You would divide \$12,000 by \$36,000, to find that 33%, or one-third, of your conversion would be tax-free.

There is one possible way around the tax. If your current employer has a retirement plan, you may be able to roll the pretax assets from your rollover IRA into it, if the plan's rules allow such a move, leaving only your nondeductible contributions subject to the pro rata rule. Remember, the pro rata rule is tied, in large part, to the balance of all your IRAs (except for Roth and inherited IRAs). So, the smaller the proportion of tax-deferred assets and earnings in the accounts, the more money you can convert tax-free. And some company retirement plans do let participants roll assets from an IRA back into a 401(k). The key: Assets in a 401(k) or similar retirement plan aren't included in pro rata calculations.

Even if you work part-time as an independent contractor, it may be worth it to open an individual 401(k) for that side business, says Julie Schatz, a certified financial planner in Menlo Park, Calif. That way, you could roll some IRA assets into your own 401(k) to help limit the tax bite on a conversion.

Of course, some employer-sponsored 401(k)s may have fewer investment options than an IRA, and many people want to move as much money as possible into a Roth, where withdrawals eventually can be tax-free. (once you meet the holding requirements). So this is mainly a strategy to consider if you are facing a significant tax bill.

There is more information about Roth IRA conversions in IRS Publication 590 at www.irs.gov.

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