IRA Insights

The benefits of a "backdoor" Roth

Vanguard research | November 2014

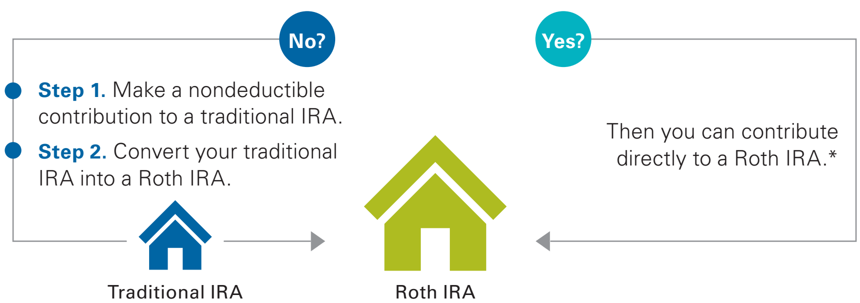
Higher-income investors who want access to Roth IRAs may need to use the back door.

IRS income limits restrict high-income investors from making Roth contributions. However, there are no income restrictions on conversions. These investors can contribute through the back door by making a nondeductible traditional IRA contribution and then converting to a Roth IRA.

From a tax standpoint, this strategy works best if you don't have other traditional IRA assets, because otherwise part of the conversion would be subject to income tax.

There are two ways to get tax-free earnings

Is your 2014 modified adjusted gross income (AGI) under $114,000 (single) or $181,000 (married filing jointly)?



* IRS phaseout rules allow single investors with AGIs of between $114,000 and $129,000 and married investors with AGIs of between $181,000 and $191,000 to make partial Roth IRA contributions.

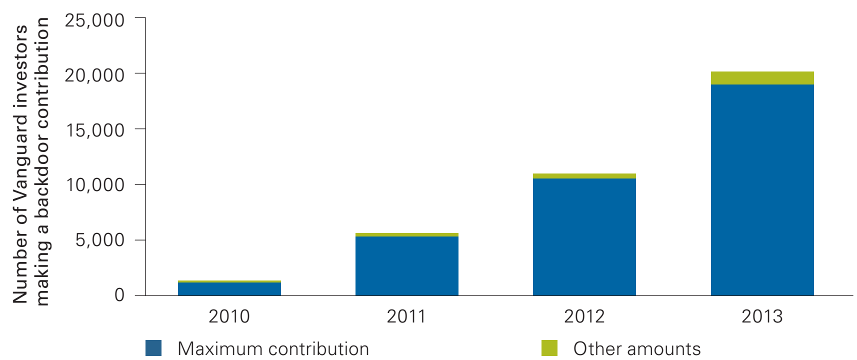
Each year, more Vanguard investors make backdoor contributions.

Since 2010, when income limits for Roth conversions were removed, the popularity of backdoor contributions has grown rapidly.

In 2013, more than 20,000 Vanguard IRA® investors who contributed to a traditional IRA converted to a Roth—almost double the number from 2012. And 94% of these contributions were the maximum amount allowed.

This is good news, but many suitable investors are still not taking advantage of this contribute-and-convert strategy.

Backdoor contributions are increasing and are usually the maximum amount



Note: Investors were assumed to have completed a backdoor Roth contribution if they made a traditional IRA contribution and a Roth conversion in the same calendar year and the conversion was within $1,000 of the contribution amount.

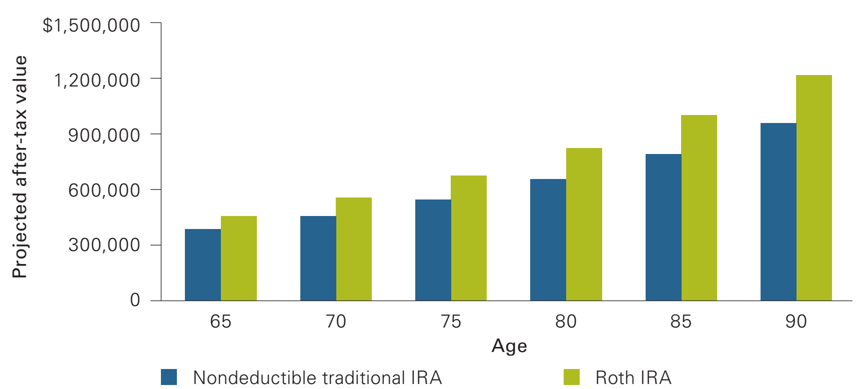
Source: Vanguard.

Over time, the tax benefit should prove well worth the additional step.

Although completing a backdoor contribution requires an additional step for high-income earners, the compounded tax-free earnings can be significant, especially for those making annual contributions.

Over the course of a lifetime, an investor who continues to contribute the maximum amount beginning at age 30 could accumulate almost $460,000 in an IRA by age 65. However, if those contributions stayed in a nondeductible traditional IRA, more than 15% would go to income taxes. By age 90, such an investor could lose more than $250,000 to taxes.

Using the back door leads to significant tax savings



Note: This figure assumes (1) amounts are in today's (2014) dollars; (2) investors make the maximum contribution beginning at age 30 and continuing through age 64; (3) the rate of return is 4% greater than inflation; (4) a 28% tax rate; (5) in the traditional IRA, RMDs begin at age 70, with after-tax net proceeds invested in a taxable account and returns taxed each year (no capital gains).

Source: Vanguard.

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The authors acknowledge John Rykaczewski in Vanguard's Client Insight group for providing the data used in this analysis.

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ISGIRA9 112014