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WEALTHY CLIENTS CLAMOR FOR BACKDOOR ROTH IRAS. ADVISORS MAY WANT TO KEEP THAT DOOR SHUT.

By: Kate Gibson - August 3, 2021

Headlines detailing PayPal founder Peter Thiel's $5 billion tax-free individual retirement account have some high-net-worth clients looking to their advisors to plot a similarly lucrative course on their behalf.

"I've gotten so many calls on this," says Neel Shah, a financial advisor and owner of Beacon Wealth Solutions in Monroe, N.J. "They all want to do what Thiel did."

Without a crystal ball or time machine, replicating Thiel's extraordinary route is not exactly feasible. As ProPublica detailed in a widely read report in June, he achieved his remarkable feat by putting pre-IPO stock worth next to nothing into a traditional IRA (which caps the dollar value of contributions) and then converting it into a Roth IRA, where it could grow to an astonishing level and one day be withdrawn tax free.

This strategy is known as a backdoor Roth IRA, since it allows wealthy people to avoid the income limits and caps on contributions of setting up Roth IRAs. Clients can't contribute to a Roth IRA in 2021 if their income is over $140,000 for single filers, or more than $208,000 for couples filing jointly. Plus, total contributions allowed each year to traditional IRAs and Roth IRAs can't be more than $6,000, or $7,000 if you're 50 or older.

Mega-backdoor IRAs take this strategy one step further using the much higher maximum limits on a 401(k). This lesser-known strategy allows for after tax-contributions of up to $58,000 a year into 401(k)s, then clients can convert some or all into a Roth. For those 50 and older, the IRS lets employees put $64,500 into 401(k) accounts.

"A mega-backdoor strategy may be worth considering for high-earning clients in their income-producing years," says Daniel Gibson, a partner at EisnerAmper in Iselin, N.J.

However, if these strategies sound too good to be true, they just may be. The task of helping high-income clients compile tax-free income for retirement can be dicey and subject to interpretation, according to Josh Simpson, vice president of operations and investment advisor with Lake Advisory Group in Lady Lake, Fla.

"There are relatively few options for high earners these days without playing in the grey areas," Simpson says. "When administrations change, the interpretation of the rule can change and you could find yourself on the wrong side."

Indeed, since ProPublica's story, some lawmakers have been calling for regulatory changes.

On July 28, House Ways and Means Committee Chairman Richard E. Neal (D-Mass.) and Senate Finance Committee Chairman Ron Wyden (D-Ore.) released new data showing a three-fold increase in mega-IRA accounts in recent years. Based on the 2019 tax year, nearly 25,000 taxpayers had aggregate IRA account balances of $5 million or more, up from 2011 data that showed only 8,000 taxpayers had IRA account balances that size.

Perhaps more startling, the 2019 data showed 497 taxpayers had aggregate IRA account balances of $25 million or more. The average account balance for that group was more than $150 million.

"It is shocking, but not surprising, to see how the use of mega-IRA accounts by mega-millionaires and billionaires has exploded," Wyden said in a statement. "IRAs were designed to provide retirement security to middle-class families, not allow the super wealthy to avoid paying taxes."

"The Ways and Means Committee is already looking at strategies to ensure that this retirement savings tool isn't misused as a tax shelter for folks at the very top," added Neal in the same statement.

Some advisors continue to see backdoor Roth accounts as a safe bet. "The IRS makes the rules, and then really smart people and their advisors figure out what they can do within the rules," says Ryan Shuchman, senior partner, Cornerstone Financial Services in Southfield, Mich. "There are many people where an IRA contribution is not tax deductible, and the backdoor Roth is absolutely something these folks should be considering," Shuchman says.

The strategy could be particularly advantageous to clients who may face higher tax rates in the future, either because the rules change or they have higher earning years ahead. "The rules are pretty clear on backdoor Roths, it's just chasing what tax bracket you want to pay," Shah says.

The decisions should be strategic, and take into account, not just income tax brackets at different phases of life, but also changing market and regulatory conditions. "We watch our clients' accounts. We might be able to convert shares when the market slides, then when the market rebounds there's more bang for your tax buck," Shah says.

For clients, discussing these options can illustrate the benefits of having a financial advisor. But for advisors, it's important to keep an eye on the changing regulatory landscape so that clients don't end up on the wrong side of any legal changes that may be coming.