TAXES TODAY

eNewsletter for Tax Professionals

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Non-Deductible IRAs: Yay or Nay?

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For this edition of Taxes Today, we will focus on answering a question many financial and tax professionals seem divided on: **Should individuals make non-deductible IRA contributions?**

Indeed, the merits of contributing to a *tax-deductible IRA* are well-understood. However, for clients that are unable to make tax-deductible IRA contributions, how should tax professionals and financial advisors/wealth managers determine whether it is advisable make non-deductible IRA contributions?

Typical of many tax planning issues, the answer is it depends.

For individuals who are unable to make deductible IRA contributions, the following steps should be taken before even considering making a non-deductible IRA contribution:

- First, the individual should ensure they are contributing to their employer retirement plan up to the employer's match.
- Second, if they currently have no traditional IRA assets, they should consider a backdoor Roth IRA contribution. If they do have traditional IRA assets, the individual will need to be mindful of the pro-rata rules and determine what the current tax costs are of a backdoor Roth IRA contribution.
- Third, the individual should consider completely maxing out their employer retirement plan (above and beyond the employer match). *Please note: This step should generally be taken before the second step should the pro-rata rules cause income to be recognized when completing a backdoor Roth IRA contribution.*

Only after completing the three steps above should an individual consider making a non-deductible IRA contribution.

In our view, non-deductible IRAs can makes sense as another means to add tax-deferred growth to an individual's investment portfolio. Understanding that a number of unpredictable future assumptions are involved in this nuanced decision, the following three questions can help an individual to determine if making non-deductible IRA contributions is in their best long-term economic interest:

- **What does the individual project their tax rate to be in retirement?** The lower the tax rate, the lower the future ordinary income taxes owed on the distributed earnings from a non-deductible IRA and ultimately, the more attractive making a non-deductible contribution will be.
- **What is the individual's current mix of taxable, tax-deferred, and tax-free assets?** We recommend that our clients have assets in each "bucket" to maximize the tax diversification of their investment portfolio. Why? Tax diversification allows for better control of both the amount a retiree pays in taxes, and when the retiree pays this amount. I encourage you to read our white paper "Tax-Efficient Retirement Income Strategies" (specifically the tax diversification section) that discusses this topic in more detail by clicking HERE.

- **What assets will be invested in the non-deductible IRA?** The less tax-efficient the assets (e.g. taxable bonds, commodities, or REITs), the more valuable the tax-deferred growth of a non-deductible IRA. Conversely, if the assets invested in a non-deductible IRA are tax-efficient, such as equity index funds, the non-deductible IRA loses much of its value.

To dive deeper into the third point, please read Jonathan Ping's well-written examples from his article *"Should I Contribute To A Non-Deductible IRA, Part 2: Better Than Regular Taxable Account?."*

If after weighing the merits of non-deductible IRA contributions, an individual believes that it makes sense to move forward, the next crucial step is tracking the basis properly so the client is not taxed twice on the non-deductible portion when funds are ultimately distributed from the IRA.

There are two ways to ensure that basis is properly tracked for a non-deductible IRA:

- **Opening a non-deductible IRA account separate from a deductible IRA account.** In the non-deductible IRA account, total contributions are simply total basis. This can become complicated if the approach selected is to open a non-deductible IRA for each year contributions are made.
- **Tracking the basis on Form 8606.** This approach is simpler from an investment perspective as you can "lump" non-deductible IRA contributions into the same account as deductible IRA contributions. However, it requires the individual/tax advisor to complete this form each year. If the Form 8606 is not properly populated each year of non-deductible IRA contributions, tracking the total basis when funds are distributed from the IRA can be very cumbersome.

I encourage you to reach out to us to interface on this non-deductible IRA question for our mutual clients (or any other clients of yours). We look forward to collaborating with you to ensure we are helping these individuals make the best decision.

On a lighter and separate topic, I found the article, *"Safe harbor issued for valuing pro sports trades,"* to be very interesting. As a San Francisco Giants fan, I am certainly hoping we trade some players to start the rebuilding process and perhaps this will help!

We are here to help.

*As always, please feel free to reach out and call (**916-405-9166**) or email (**spitchford@towerpointwealth.com**) with any questions, thoughts, or needs you may have. At Towerpoint Wealth, we are happy to be a direct and no-strings-attached resource for you.*

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