Episode #223: Biden's Proposed Plan Eliminates Backdoor Roth IRAs & Limits Conversions

Video Transcription

Hi, welcome to another episode of "Money Script Monday," my name is Brian Manderscheid. Today, I want to talk about how Biden's proposed plan eliminates backdoor Roth IRAs, and limits conversions.

What I want to start off by saying is, as of the date this video was recorded, the Build Back Better Plan has not yet passed. It does face fierce opposition in the Senate. While the bill may or may not pass, we do have many clients who are concerned about future tax rate increases, excessive amounts of government spending and are looking for vehicles to hedge against future tax rate increases and put money away for tax-free income in the future.

This bill, the Build Back Better bill, prevents some of the popular strategies our clients are using to again, hedge against tax rate increases. We're going to talk about how this bill may affect retirement plans and a solution that you can implement today.

First, let's talk about some of the changes that are being proposed on retirement planning strategies. The first being, backdoor Roth IRAs. Again, I mentioned that a lot of our high-net-worth clients, high income-earning clients are concerned about future tax rate increases and they've used strategies like this to put money into a tax-free vehicle. The reason being is a Roth IRA has phase-out ranges and the 2022 Modified Adjusted Gross Income limits or phase-out ranges are $129,000 to $144,000 for single, and $204,000 for to $214,000 for married filing jointly.

What this means is that if you make over and above those limits, you are exempt from contributing to a Roth IRA. Instead, you can do what's called a backdoor Roth IRA, where you contribute to a non-deductible IRA and immediately convert that to a Roth. It's essentially a loophole to get around the income phase-out ranges for a Roth IRA.

One of the potential issues is that the contribution limits are relatively low. For 2022, you can contribute $6,000 a year to a Roth or backdoor Roth and another $1,000 or $7,000 total, if you're 50 or older.

Another strategy is a mega backdoor Roth. A mega backdoor Roth is essentially contributing after-tax money in your 401(k), your employer-sponsored plan, and converting that money outside the plan to a Roth IRA. For 2022, the limit is $40,500 and that's over and above the $20,000 max 401(k) contribution limit.

Now, there is no income phase-out range for this program. However, this is very niche because very few retirement plans actually allow you to contribute after-tax money into the 401(k), and also allow you to convert that outside the plan to a Roth IRA. While this has some benefits, again, a lot you can contribute to and no income limits, but very, very few clients can actually implement this type of plan.

Additionally, the Build Back Better program basically eliminates the ability to convert after-tax IRAs or 401(k)s to a Roth IRA. Both of these programs are essentially eliminated if the Build Back Better program does pass.

Now, moving away from contributing to a tax-free vehicle, like a Roth IRA, let's talk about Roth IRA conversions. Let's say you have money already built up pre-tax in an IRA or 401(k), you see the writing on the wall, so to speak. You believe that future tax rates are going to be higher.

We have this short window here before the Tax Cuts and Jobs Act expires and sunsets in 2026, or tax rates we know are going to jump up higher. You want to convert some of that money, pay the taxes now while we know what they are, and have all the growth distribution transfer be taxed moving forward. That's a Roth IRA conversion.

The problem is the Build Back Better program is at the discussing at least putting income limits on Roth IRA conversions. As of right now, it doesn't matter how much money you make, you can contribute to Roth. You can convert a pre-tax IRA or 401(k) to an IRA. However, with the BBB plan effective 2031, the income limits are $400,000 if you're single, $450,000 married filing jointly.

Additionally starting 2028, those income limits will be adjusted for inflation. They'll actually potentially be higher based on whatever inflation rates are. So problem is that if you want to do a Roth IRA conversion, not only do you have the Tax Cuts and Jobs Act window closing in 2026, but you also have the potential for Roth IRA conversions to be not allowed in 2031 based on your income.

There are plenty of other additional items in the Build Back Better plan that affect retirement accounts, one being no more contributions if you make a certain amount of money or have a certain retirement account size and also required minimum distributions, if your account balance starts to exceed a certain level, essentially preventing the account from growing either tax-deferred or tax-free.

So while there are, again, a lot of restrictions being talked about to get a tax-free income from retirement accounts, there is something that you can implement today, and that is a maximum efficient Indexed Universal Life.

Now, a maximum efficient IUL is essentially taxed or almost identically to a Roth IRA. The account grows tax-deferred, accessible income tax-free, the life insurance death benefit transfers income tax-free as well. One of the big benefits of the Indexed Universal Life outside of a Roth IRA is that there's an unlimited contribution limit, or essentially, you set the contribution limit, not the IRS.

For that Roth IRA, you can only contribute $6,000 per year. For the Indexed Universal Life policy, you actually set that bar. There's something called the seven 7-pay MEC limit, and it's essentially an amount that if you contribute over and above, the policy becomes a modified endowment contract, and you lose some of those tax favor benefits. Big thing is that you set the line based on the amount of insurance you purchase.

For example, the more insurance you buy, the higher your MEC limit is, the higher the contribution amount. The lower amount of insurance you buy, the lower the contribution limit. You set the bar, not the IRS. There are also contractual guarantees in these policies and in the investment world, we can't promise results or provide guarantees. In the insurance world, there are many guarantees.

One of which is a 0% annual floor. The way this works is let's say the stock market goes down by 20% or 30%, you would receive a 0% credit, meaning that you would not lose money even though the stock market dropped. While everyone else in the following year is trying to catch back up to what to even the beginning balance before the loss, before the stock market crash, you'd be capturing gains in the stock market based on a limiting factor, like a cap participation rate.

There's also a minimum interest rate guarantee. Let's say we hit a, you know, sustain into the bear market period, there's a contractual minimum rate of return that you'd receive that varies from company to company. Likewise, there's a maximum loan rate. The way these policies work, if you need tax-free income, you borrow from the life insurance company with your cash value and death benefit as collateral. Your cash value continues to grow uninterrupted even though you've borrowed money on an outstanding loan balance against the account.

Now, when you borrow from the company, there's a loan rate. And the loan rates with many companies are set contractual guaranteed. There's either a set rate or a maximum cap limit that the insurance company can never charge greater than. If we get into a hyperinflationary period your contractual loan rates are set, so while everyone else is borrowing from a bank at potentially double-digit rates, you're borrowing at potentially five or lower in many of these contracts.

Additionally, to all these other benefits I mentioned, is in back in the end of 2020, the Consolidated Appropriations Act of 2021 passed, which is essentially a way to keep the government running. It was a budget bill and buried within this bill was a little provision that basically reduced the section 7702 guidelines on these life insurance policies.

Said in another way, it reduced the amount of life insurance that you need to carry based on the desired level of funding. Buying less life insurance means that you have lower life insurance policy costs and expenses. Not only do you get all these benefits that I mentioned, but based on buying a policy today, you also carry a lower cost than policies purchased in the past.

I mentioned that the Build Back Better Bill has some pretty detrimental to retirement programs and essentially limits individuals from contributing or converting to Roth IRAs. I also talked about how there is a vehicle you can start today that you set the contribution limit, not the IRS. Allows you to get contractual guarantees upside the stock market without stock market losses, while also being taxed very similarly to Roth IRA.

If this is something that you're looking for in your financial plan, please contact the advisor who sent you this video to get started today.

Thank you very much. We'll see you next time.